Federal Liens and Priorities—Agenda for the Next Decade*

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It is more than 10 years since the American Bar Association—at first through several of its Sections, but since 1958 through a Special Committee on Federal Liens—began the studies which culminated in the Federal Tax Lien Act of 1966,¹ the first significant reform of the law of federal tax liens and collection procedures in more than half a century.² The things which that law accomplished have been detailed elsewhere,³ and will merely be summarized here as background for a discussion of the unfinished business, the problem areas—involving not only federal taxes but federally held mortgages, judgments and unsecured non-tax claims—to which the Bar should now direct its attention.⁴ Not all the proposals dealt with herein are of equal merit or urgency. My purpose is to lay them open to study and discussion, and to preserve the record of the work that has been done.⁵ Perhaps, now that the ground has been broken by the recent enactment, the pessimism implied in the title will prove unwarranted, and those proposals which survive scrutiny can be enacted in much less than another decade.

Since the several parts of this paper may appeal to different specialized interests, an outline may be helpful:

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1. Pub. L. 89-719, 80 Stat. 1125 (1966), codified in scattered sections of 26 U.S.C. (Supp. II, 1965-66).

2. The last major change, in 1913, overturned the rule of *United States v. Snyder*, 149 U.S. 210 (1893), by protecting purchasers, mortgagees and judgment creditors against the otherwise secret federal tax lien unless notice thereof was filed. 37 Stat. 1016 (1913).

3. See Plumb, *The New Federal Tax Lien Law*, 22 BUS. LAW., Jan. 1967, at 271, revised and expanded in 13 PRAC. LAW., Mar. 1967, at 63, and 13 PRAC. LAW., Apr. 1967, at 67; Creedon, *The Federal Tax Lien Act of 1966*, 20 ABA TAX SECTION BULL., Jan. 1967, at 101. The changes in the law have been incorporated in W. PLUMB & L. WRIGHT, *FEDERAL TAX LIENS* (1967), published by the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association.

4. The Special Committee on Federal Liens was discharged at the February 1967 meeting of the American Bar Association, and its responsibilities were returned to the interested Sections.

5. Except as expressly stated hereinafter, these proposals are solely the responsibility of the writer, and have not been passed upon by the American Bar Association or the Special Committee.

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- I. By Way of Background: Federal Taxes and "Inchoate" Non-Federal Liens

Every federal tax which is not paid on demand becomes a lien "upon all property and rights to property, whether real or personal, belonging to . . ." the taxpayer.⁶ It arises as a secret lien, effective from the date of assessment of the tax.⁷ When Congress first provided for the lien, at the close of the Civil War,⁸ the secret lien prevailed over even a later bona fide purchaser.⁹ But Congress, even before the 1966 legislation, had shown an increasing awareness of the public importance of security of titles, and of the need of certain creditors to be able to rely upon the taxpayer's apparent unencumbered ownership of his property. In 1913 Congress protected purchasers, mortgagees and judgment creditors,¹⁰ and in 1939 pledgees,¹¹ against federal tax liens of which notice had not been duly filed in a designated office. Further, Congress had gradually recognized that searching for federal tax liens is impracticable in certain cases, and it accordingly had provided "superpriorities"—*i.e.*, priority even over existing and filed tax liens, if prescribed conditions were met—in 1939 for purchasers and lenders on the security of "securities,"¹² and in 1964 for purchasers of motor vehicles.¹³

As against the taxpayer himself and all other classes of creditors, however, the federal tax lien remained effective from the time of assessment without need for public notice of any kind. In regulating the competition between federal tax liens and those non-federal liens not

6. INT. REV. CODE of 1954, § 6321. After-acquired property is reached by the lien. *Glass City Bank v. United States*, 326 U.S. 265 (1945).

7. INT. REV. CODE of 1954, § 6322; *United States v. City of New Britain*, 347 U.S. 81 (1954).

8. Act of July 13, 1866, ch. 184, § 9, 14 Stat. 107. See also Act of March 3, 1865, ch. 78, 13 Stat. 470.

9. *United States v. Snyder*, 149 U.S. 210 (1893).

10. Act of March 4, 1913, ch. 166, 37 Stat. 1016.

11. Revenue Act of 1939, § 401, 53 Stat. 882.

12. *Id.*

13. INT. REV. CODE of 1954, § 6323(b)(2), which originated in Revenue Act of 1964, § 236, 78 Stat. 127.

expressly mentioned in the statute, the Supreme Court paid lip service to the principle that "the first in time is the first in right," but it nullified that principle by prescribing that in order to be "first in time" the nonfederal lien must first have become "choate."¹⁴ That word "choate," an illegitimate back formation which was not in most dictionaries until the Supreme Court gave it currency,¹⁵ was not truly an antonym for "inchoate." A lien might be complete and perfected for every purpose of state law, and hence not "inchoate" as we understand that term. Yet it would also not be "choate," by federal judicial standards, unless (1) the identity of the lienor, (2) the property subject to the lien, and (3) the amount payable were fixed beyond possibility of change or dispute.¹⁶

Except for certain possessory liens¹⁷ and certain state and local tax liens (if they attached to definite property, in amounts assessed and determined, and were summarily enforceable without judicial proceedings),¹⁸ no common law, equitable or statutory lien could meet that judicial standard of "choateness" until the lienor's claim had been reduced to judgment.¹⁹ This requirement frustrated the efforts of generations of courts and legislatures to fashion protections for those who must rely on the security of a debtor's property but for whom contractual security interests may not afford a practical solution. Landlords' liens,²⁰ equitable vendors' liens,²¹ attachments before judgment,²² and many other liens²³—including, before the 1966 legislation, mechanics'²⁴ and attorneys' liens²⁵—failed the "choateness" test, and hence

14. *United States v. City of New Britain*, 347 U.S. 81 (1954). See Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905 (1954).

15. The word, derived from "inchoate" by dropping a prefix that means "on" rather than "not," was characterized as "a flag of the new freedom from etymology" in Letter from Alfred F. Conard, 42 A.B.A.J. 608 (1956). See also *Hammes v. Tucson Newspapers, Inc.*, 324 F.2d 101, 102 (9th Cir. 1963).

16. *United States v. Pioneer American Ins. Co.*, 374 U.S. 84, 89 (1963).

17. *United States v. Toys of the World Club, Inc.*, 288 F.2d 89 (2d Cir. 1961). See Part IV.B.10 in the second installment of this article.

18. *United States v. Vermont*, 377 U.S. 351 (1964) (lien attached to "all" property and was summarily enforceable); *United States v. City of New Britain*, 347 U.S. 81 (1954) (real property tax).

19. See *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956), discussed *infra* note 24.

20. *United States v. Scovil*, 348 U.S. 218 (1955). See Part IV.B.7, in the second installment of this article.

21. *United States v. Morrison*, 247 F.2d 285 (5th Cir. 1957).

22. *United States v. Acri*, 348 U.S. 211 (1955). See Part IV.B.9, in the second installment of this article.

23. Including state and local liens not meeting the standards, note 18 *supra*. See Part IV.C.1 in the second installment of this article.

24. In *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956) *rev'g mem.* 227 F.2d 359 (7th Cir. 1955), the Court gave a federal tax lien priority in the property im-

the holders were vulnerable not merely to pre-existing secret tax liens, but also to those which arose by assessment after they had perfected their own liens as against everyone else. Even mortgages and other contractual security interests, despite their specially favored position under the federal statute,²⁶ were vulnerable before 1966 to subsequently filed federal tax liens to the extent that the security embraced after-acquired property²⁷ or involved disbursements (whether optional or obligatory) yet to be made,²⁸ including foreclosure expenses and other outlays for which a mortgagee normally is entitled to a lien with the same priority as the principal debt.²⁹ Furthermore, contract purchasers of property, who had taken possession but had not yet paid enough to be entitled to deeds, were deemed not to have "choate" interests in the property and hence were vulnerable before 1966 not only to pre-existing unfiled liens but to liens for taxes subsequently assessed against the sellers.³⁰

An inevitable consequence of the conflict of state and federal systems of lien priority was that "circular priority" situations frequently arose. The conflict was resolved, not at the expense of the non-federal lien that failed the "choateness" test, but at the expense of a mortgagee or other fully perfected and "choate" interest which had, in all other respects, priority over the federal tax lien. Suppose, for example, that a \$10,000 mortgage had priority under *federal* law over a \$15,000 federal tax lien, which had priority under *federal* law over a \$3,000 state

proved by the mechanic's lienor, even though the federal interest arose only after such lienor had completed his work, had perfected his lien under state law, and had commenced suit to enforce it. The adverse reaction to such "unjust enrichment" of the Federal Government through "appropriating the labor and materials of workmen to the tax delinquency of another" (*United States v. Vorreiter*, 134 Colo. 543, 307 P.2d 475, *rev'd*, 355 U.S. 15 (1957)) probably gave the greatest impetus to the reform movement which culminated in the 1966 Act.

25. *United States v. Pay-O-Matic Corp.*, 162 F. Supp. 154 (S.D.N.Y. 1957), *aff'd sub nom. United States v. Goldstein*, 256 F.2d 581 (2d Cir.), *cert. denied*, 358 U.S. 830 (1958).

26. The only significance accorded to the statutory favor (former § 6323(a)) was to apply the "choateness" test to the security interest as of the date the federal lien was filed rather than as of the assessment date. *United States v. Pioneer American Ins. Co.*, 374 U.S. 84 (1963).

27. *Dean Constr. Co. v. Simonetta Concrete Constr. Co.*, 65-1 U.S. Tax Cas. ¶ 9253, 37 F.R.D. 242 (S.D.N.Y. 1965); *In re Hudon & Son, Inc.*, 65-2 U.S. Tax Cas. ¶ 9517 (D. Mass. 1964); *Randall v. Colby*, 190 F. Supp. 319, 341 (N.D. Iowa 1961); *Stockholders Pub. Co. v. Smith*, 56-1 U.S. Tax Cas. ¶ 9420 (S.D. Calif. 1956).

28. *United States v. R.F. Ball Constr. Co.*, 355 U.S. 587 (1958); *American Surety Co. v. Sundberg*, 58 Wash. 2d 337, 363 P.2d 99 (1961), *cert. denied*, 363 U.S. 939 (1962). See Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government against the Inchoate Lien*, 50 Iowa L. Rev. 724, 735 (1965).

29. *United States v. Equitable Life Assur. Soc'y*, 384 U.S. 323 (1966); *United States v. Pioneer American Ins. Co.*, 374 U.S. 84 (1963); *United States v. Bond*, 279 F.2d 837 (4th Cir.), *cert. denied*, 364 U.S. 895 (1960).

30. *Leipert v. Williams & Co.*, 161 F. Supp. 355 (S.D.N.Y. 1957); *cf. United States v. Creamer Industries*, 349 F.2d 625 (5th Cir. 1965).

or local tax lien (or a mechanic's lien, landlord's lien or attachment), which in turn had priority under *state* law over the mortgage. Upon foreclosure, suppose the property produced \$24,000, which was insufficient to satisfy the \$28,000 in liens. The solution adopted by the Supreme Court was first to set aside the amount of the prior mortgage (\$10,000), leaving \$14,000 to be applied on the federal claim, which under federal law was junior only to the mortgage. From the \$10,000 which had been set aside, \$3,000 would be applied on the lien which had priority over the mortgage under state law, leaving \$7,000 for the mortgagee—who, were it not for the *junior* federal tax lien, would have been amply protected by equity cushion against any impairment of his interest by property tax delinquencies.³¹

A fundamental objective of the federal tax lien reform was to overcome the inequity of the "choateness" rule. Although the rule was not wholly eliminated,³² Congress granted specific relief in a number of meritorious situations and, on the whole,³³ achieved equity in a field that had been notorious for its absence. Mechanics' lienors,³⁴ sureties, commercial and construction lenders,³⁵ contract purchasers³⁶ and others now enjoy a protection against unfilled federal tax liens which, if not complete, is nonetheless far better than they have known before. Mortgagees are now protected in the outlays they make for enforcement or protection of their interests,³⁷ and federal recognition of the superpriority of liens for state and local property taxes, special assessments, and public service charges³⁸ has removed the major source of

31. *United States v. Buffalo Sav. Bank*, 371 U.S. 228 (1963); *United States v. City of New Britain*, 347 U.S. 81 (1954). See Creedon, *On Mortgage Foreclosures and Federal Tax Liens*, 18 BUS. LAW. 1117 (1963).

32. See H.R. REP. NO. 1884, 89th Cong., 2d Sess. 35 (1966). No relief was granted, for example, for landlords' liens, attachments, and equitable liens, and the "choateness" requirement for security interests and mechanics' liens was redefined rather than wholly eliminated.

33. A few qualifications of this statement are expressed in Part IV.B, in the second installment of this article.

34. INT. REV. CODE OF 1954, § 6323(a), (h)(2). Regardless of state laws setting an earlier date, mechanics' liens are still not protected before the date when the particular lienor begins to furnish services, labor or materials; and the superpriority which some States grant to mechanics' liens, to the extent of the added value of the improvements, is not recognized. See Part IV.B.6, in the second installment of this article. But at least the prospective mechanics' lienor can now protect himself by a search at the prescribed time.

35. INT. REV. CODE OF 1954, § 6323(c) and (d) deal with security interests involving future advances and after-acquired property. Certain imperfections in the statute are discussed in Part IV.B.3, in the second installment of this article.

36. INT. REV. CODE OF 1954, § 6323(h)(6). See Part IV.B.4, in the second installment of this article.

37. INT. REV. CODE OF 1954, § 6323(e).

38. INT. REV. CODE OF 1954, § 6323(b)(6). As a result, in the example *supra* at note 31, both the property tax and the mortgage would be satisfied *in full* before anything is applied on the federal claim.

the circular priority inequity.³⁹ The list of those entitled, under prescribed conditions, to superpriorities—and hence relieved of the risk of existing filed federal tax liens for which it would rarely be feasible for them to search—has been further expanded to embrace retail and certain “casual” purchasers, certain possessory lienors, mechanics’ lienors on certain small residential jobs, attorneys, and institutions lending on the security of their own passbooks and life insurance policies.⁴⁰

Truly it could be said, to borrow a phrase used by Justice Cardozo in another connection, that a “high-minded Government renounced an advantage that was felt to be ignoble, and set up a new standard of equity and conscience.”⁴¹ But, as we shall next see, the benefits of the hard-won and much needed reforms can be nullified if the taxpayer becomes “insolvent”⁴² but bankruptcy does not ensue—the very circumstance in which the newly enacted protections would otherwise become of crucial importance.⁴³

II. Priorities and Other Problems in Insolvency and Bankruptcy

A. *The Conflicting Priority Rules*

An ancient federal statute, commonly referred to as Section 3466 of the Revised Statutes, provides that in certain cases of insolvency “the debts due to the United States shall be first satisfied.”⁴⁴ That law, dat-

39. The example in the text would still be applicable, however, if the lien having *state law* priority over the mortgage is an antecedent attachment (*Manchester Fed. Sav. & Loan Assn. v. Emery-Waterhouse Co.*, 102 N.H. 233, 153 A.2d 918 (1959)), a landlords’ lien (*Brock v. Slater*, 56-2 U.S. Tax Cas. ¶ 9605 (N.D. Ala. 1965)), a state or local tax lien other than for a real property tax (*United States v. Schroeder*, 204 F. Supp. 199 (S.D. Iowa 1962)), or a mechanics’ lien enjoying a higher priority under state law than Congress (note 34 *supra*) was willing to grant it. *Samms v. Chicago Title & Trust Co.*, 349 Ill. App. 413, 111 N.E.2d 172 (1953).

40. INT. REV. CODE of 1954, § 6323(b). See Part IV.B.4, 6, 8, 10, in the second installment of this article.

41. *George Moore Ice Cream Co. v. Rose*, 289 U.S. 373, 379 (1933).

42. The circumstances giving rise to the “insolvency” priority are detailed at pp. 237-39 *infra*.

43. “If the assets of a debtor or his estate are adequate to pay all his debts, every claim will be paid and the issue before us is then unimportant. If a debtor is solvent, no claim is imperiled. It is only when the funds are not sufficient to pay all claims, that the question of priority becomes of real interest, . . .” *In re Meyer’s Estate*, 159 Pa. Super. 296, 301, 48 A.2d 210, 213 (1946). While the vast outpouring of lien priority litigation in the ensuing years evidences that the court understated the importance of priorities in the absence of technical insolvency, there is no doubt that insolvency magnifies the problem.

44. Rev. Stat. § 3466, 31 U.S.C. § 191 (1964):

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, con-

ing from the earliest days of our Nation and never substantively amended since 1799,⁴⁵ "applies to all the insolvent's debts to the Government, whether or not arising from taxes, and whether or not secured by a lien."⁴⁶ The statute creates no lien in favor of the United States, so the fiduciary administering the insolvent's estate is free, if he otherwise would be, to sell and pass clear title to property.⁴⁷ But, at the point of distribution, the priority statute has an effect on the other creditors of the insolvent which is more drastic than any lien.

1. *Priority Rules*

The Bankruptcy Act, with some exceptions, leaves pre-existing liens unimpaired, and establishes a ranking of unsecured claims in which the Government stands no better than fourth.⁴⁸ In contrast, the federal priority in non-bankruptcy insolvency, on the face of Section 3466, is absolute and "permits no exception whatsoever. . . ."⁴⁹ The Supreme Court has made clear that a statutory lien on *personalty* cannot prevail in insolvency even if it satisfies the exacting federal "choateness" test of certainty of the lienor, the property and the amount, unless in addition either title or possession has passed to the lienor before the federal priority attaches.⁵⁰ And while there is some doubtful⁵¹ lower court authority that would recognize, without passage of title or possession, the priority of a "choate" lien on *real estate* securing a property tax or a judgment,⁵² the Supreme Court has persistently and pointedly

ceased, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

The priority statute is discussed in more detail in W. PLUMB & L. WRIGHT, *supra* note 3, ch. 6. See also Kennedy, *supra* note 14; Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 459, 480 (1958).

45. The provision traces to the Act of July 31, 1789, ch. 5, § 19, 1 Stat. 42, the fifth statute enacted by the First Congress, and has been substantially in its present form since the Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515. The Act of March 2, 1799, ch. 22, § 65, 1 Stat. 676, added the companion provision (now found in Rev. Stat. § 3467, 31 U.S.C. § 192 (1961), *infra* note 173) imposing personal liability on one who makes payments in disregard of the priority. See *King v. United States*, 379 U.S. 329, 334-35 (1964).

46. See *United States v. Vermont*, 377 U.S. 351, 357 (1964). A federal tax will enjoy the priority even though it had not been assessed or become a lien before the insolvency. *Viles v. Comm'r*, 233 F.2d 376, 379-80 (6th Cir. 1956).

47. *United States v. Oklahoma*, 261 U.S. 253, 259 (1923).

48. 11 U.S.C. §§ 104, 107 (Supp. II, 1965-66). See notes 89-107 *infra*.

49. See *United States v. Vermont*, 377 U.S. 351, 357 (1964).

50. *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953). See also *United States v. Davis*, 247 F. Supp. 84 (E.D. Mich. 1965), *aff'd sub nom. United States v. County of Wayne*, 378 F.2d 671 (6th Cir. 1967), *petition for cert. filed*, 36 U.S.L.W. 3101 (U.S. Sept. 11, 1967) (No. 599).

51. See *Thelusson v. Smith*, 15 U.S. (2 Wheat.) 396 (1817); *United States v. Morrison Industries, Inc.*, 227 F. Supp. 974 (N.D. Ohio 1963).

52. *Property tax: United States v. Atlantic Municipal Corp.*, 212 F.2d 709 (5th Cir. 1954); *In re Kirkman Furniture Co.*, 258 N.C. 733, 129 S.E.2d 471 (1963); *United States v.*

reserved opinion thereon.⁵³ It is unquestionable, at least, that mechanics' liens and other liens that fail the "choateness" test as it was applied in federal tax lien cases before 1966⁵⁴ remain ineffective against the federal insolvency priority.⁵⁵

The Government, apparently as a matter of policy, has rarely pursued very seriously the Supreme Court's further gratuitous suggestion that even a mortgage, in a state where it operates as a lien rather than as a conveyance of title, may be subordinate to the federal priority in insolvency.⁵⁶ The lower courts, on the few occasions when the question has arisen, have uniformly upheld the priority of both a conventional mortgage⁵⁷ and a common law pledge.⁵⁸ But a security assignment of intangibles, or any other less conventional security interest, may well be vulnerable.⁵⁹ And those mortgages and security interests which formerly failed the "choateness" test in federal tax lien cases because they embraced a shifting mass of collateral or secured future advances (including obligatory disbursements and foreclosure expenses)⁶⁰ would surely fare no better against the federal insolvency priority.⁶¹ More-

South Carolina, 227 S.C. 187, 87 S.E.2d 577 (1955). *Judgment*: *Muniz v. United States*, 129 Ind. App. 433, 155 N.E.2d 140 (1958); *United States v. South Carolina*, *supra*; *In re Meyer's Estate*, 159 Pa. Super. 296, 48 A.2d 210 (1946). Although the Supreme Court had declared an unenforced judgment lien on realty to be subordinate to the federal priority in *Thelusson v. Smith*, 15 U.S. (2 Wheat.) 396 (1817), the court in *Meyer* concluded that the protection which Congress later accorded judgment liens as against federal tax liens (in what is now INT. REV. CODE OF 1954, § 6323(a)) implied a like amendment of Rev. Stat. § 3466. See note 112 *infra*.

53. See *United States v. Vermont*, 377 U.S. 351, 357 (1964); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361, 365 (1953); *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 355 (1945). See Kennedy, *supra* note 28, at 726-27.

54. See p. 230 *supra*.

55. *Mechanics' liens*: *W. T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963). *Landlords' liens*: *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945); *United States v. Saidman*, 231 F.2d 503 (D.C. Cir. 1956); *United States v. Menier Hardware No. 1, Inc.*, 219 F. Supp. 448 (W.D. Tex. 1963). *State and local tax liens*: *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946); *United States v. Texas*, 314 U.S. 480 (1941); *New York v. Maclay*, 288 U.S. 290 (1933).

56. *New York v. Maclay*, 288 U.S. 290, 294 (1933).
57. A district court decision subordinating a chattel mortgage to the federal priority, for lack of title or possession in the mortgagee, was reversed in *Exchange Nat'l Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141, 143 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957). See also *United States v. Guaranty Trust Co.*, 33 F.2d 533, 537 (8th Cir. 1929), *aff'd on other grounds*, 280 U.S. 478 (1930); *United States v. Lebanon Woolen Mills*, 241 F. Supp. 393, 395 (D.N.H. 1964); *Bank of Wrangell v. Alaska Asiatic Lumber Mills, Inc.*, 84 F. Supp. 1 (D.Alaska 1949); *Evans v. Stewart*, 245 Iowa 1268, 66 N.W.2d 442 (1954). The Government did not question the priority of the mortgage in either *United States v. Texas*, 314 U.S. 480 (1941), or *Southern Ry. v. United States*, 306 F.2d 119, 125-26 (5th Cir. 1962).

58. *In re Decker's Estate*, 355 Pa. 331, 341, 49 A.2d 714, 719 (1946), *cert. denied*, 331 U.S. 807 (1947); *In re Levy's Estate*, 70 N.Y.S.2d 72 (N.Y. Surr. Ct. 1947). The Government conceded the pledgee's priority in *In re Bushway's Estate*, 107 N.H. 135, 218 A.2d 49 (1966).

59. *In re Gruner*, 295 N.Y. 510, 68 N.E.2d 514 (1946) (security assignment of Stock Exchange seat subordinated to federal priority, as a mere inchoate equitable lien).

60. P. 231 *supra*.

61. Contractual security interests of landlords, for example, have been subordinated

over, as was true until 1966 with respect to federal tax liens,⁶² even a mortgagee or other secured creditor whose superiority over a federal claim is recognized may nevertheless lose out under the circular priority principle if some other lien or claim which state law prefers over the mortgage is nevertheless inferior to the federal insolvency priority.⁶³

Needless to say, since even prior liens are thus treated, the federal priority also overrides any higher priority which state law may attempt to provide for *unsecured* creditors, such as wage claimants,⁶⁴ insurance policyholders,⁶⁵ and bank depositors,⁶⁶ as well as for state and local taxes assessed after the federal claim⁶⁷ and expenses of an insolvent decedent's last illness.⁶⁸ On the other hand, by long construction rather than by the express terms of the law, the federal priority does yield to administration expenses,⁶⁹ funeral expenses,⁷⁰ and in some jurisdictions allow-

to the federal priority on the ground that the liability and the property covered by the lien were subject to change. *United States v. Menier Hardware No. 1, Inc.*, 219 F. Supp. 448, 454 (W.D. Tex. 1963); *Terry v. Title & Trust Co.*, 207 Ore. 356, 295 P.2d 161 (1956); *cf. United States v. Waddill, Holland & Flinn, Inc.*, 373 U.S. 353 (1945) (landlord's lien). The mere possibility that after-acquired property might be added was fatal to *statutory* liens in *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946), and in *United States v. Texas*, 314 U.S. 480 (1941). Although a pledge securing future advances was held effective against the federal priority in *Union Guardian Trust Co.*, 41 B.T.A. 1306 (1940), *acquiesced in*, 1940-2 CUM. BULL. 7, the advances were in fact made before the federal priority attached. More to the point is *United States v. Hooe*, 7 U.S. (3 Cranch) 73 (1805), which preferred a deed of trust given to indemnify a surety and endorser, who had not made payment before the debtor died insolvent. *See also Brent v. Bank of Washington*, 35 U.S. (10 Pet.) 594 (1836). But the present weight of ancient authority in this field is questionable. Kennedy, *supra* note 14.

62. Pp. 232-33 *supra*.

63. *Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957); *United States v. Morrison Indus., Inc.*, 227 F. Supp. 974 (N.D. Ohio 1963).

64. *United States v. Emory*, 314 U.S. 423 (1941). The federal priority cannot be defeated by a "lien" for wages, which arises only by virtue of the insolvency itself. *United States v. Division of Labor Law Enforcement*, 201 F.2d 857 (9th Cir. 1953). Regarding wage priorities in bankruptcy, see note 92 *infra*.

65. *United States v. Knott*, 298 U.S. 544 (1936). *But see Conway v. Imperial Life Ins. Co.*, 207 La. 285, 21 So. 2d 151 (1945).

66. *United States v. Bliss*, 40 F.2d 935 (D. Neb. 1930), *aff'd*, 44 F.2d 909 (8th Cir. 1930).

67. *Spokane County v. United States*, 279 U.S. 80 (1929). In bankruptcy, see TAN and note 94 *infra*. A District of Columbia statute which, in terms similar to Rev. Stat. § 3466, gives absolute priority to claims for District sales taxes, was construed to override the federal insolvency priority (which it could validly do, since both were enacted by Congress). *United States v. Saidman*, 231 F.2d 503, 508-10 (D.C. Cir. 1956). But the same District statute was construed as not intended to elevate the District's claim in *bankruptcy* above the fourth priority it would enjoy under the Bankruptcy Act. *District of Columbia v. Greenbaum*, 223 F.2d 633 (D.C. Cir. 1955).

68. *In re Estate of Shoptaw*, 54 Wash. 2d 602, 343 P.2d 740 (1959); *In re Estate of Muldoon*, 128 Cal. App. 2d 284, 275 P.2d 597 (1954); S.M. 5032, V-1 CUM. BULL. 109 (1926); G.C.M. 4217, VII-2 CUM. BULL. 162 (1928). *But see McCain v. Liberty Nat'l Bank*, 54-1 U.S. Tax Cas. ¶ 9141 (N.D. Ga. 1953).

69. *Abrams v. United States*, 274 F.2d 8 (8th Cir. 1960); *Kennebec Box Co. v. O.S. Richards Corp.*, 5 F.2d 951 (2d Cir. 1925); *United States v. Weisburn*, 48 F. Supp. 893 (E.D. Pa. 1943); *Jessie Smith*, 24 B.T.A. 807, 811 (1931). The expenses of operating a

ances for the support of widows and children,⁷¹ on the theory that such items are charges against the estate rather than debts of the insolvent. When an insolvent estate is itself insolvent, the Government contends that the estate is itself an insolvent debtor to which the federal priority applies, and that those federal claims which rank as administration expenses are to be paid before receivership certificates and other expenses, except court costs and fees of receivers and attorneys;⁷² but on this the authorities are divided.⁷³

2. *Applicability of the Statute*

As Section 3466 of the Revised Statutes has been construed by the courts, the mere insufficiency of assets to pay debts, although a prerequisite,⁷⁴ is not by itself enough to make the federal priority applicable,⁷⁵ except in the case of a decedent's estate. In the case of a living debtor, the insolvency must be manifested by one of the following formal acts: (1) a "voluntary assignment," made by one not having sufficient property to pay his debts; (2) the attachment of the estate and effects of an absconding, concealed or absent debtor; or (3) the commission of an act of bankruptcy⁷⁶ (which, under the present Bankruptcy Act, would include a general assignment for creditors even if insolvency does not exist at the time of the assignment,⁷⁷ and the appoint-

business in receivership (including taxes) are administration expenses. *Southern Ry. v. United States*, 306 F.2d 119, 125-28 (5th Cir. 1962).

70. *United States v. Weisburn*, 48 F. Supp. 393 (E.D. Pa. 1943); S.M. 5032, V-1 CUM. BULL. 109 (1926), and G.C.M. 4217 VII-2 CUM. BULL. 162 (1928).

71. *United States v. Weisburn*, 48 F. Supp. 393 (E.D. Pa. 1943); *Jessie Smith*, 24 B.T.A. 807 (1931); *In Re Estate of Carl*, 43 Ohio Op. 52, 94 N.E.2d 239 (P. Ct. 1950); I.T. 2712, XII-2 CUM. BULL. 138 (1933); I.T. 2518, IX-1 CUM. BULL. 158 (1930); G.C.M. 4217, VII-2 CUM. BULL. 162 (1928); I.T. 2430, VII-2 CUM. BULL. 72 (1928). *But cf. In re Estate of Ballard*, 57-2 U.S. Tax Cas. ¶ 9777 (Mich. P. Ct. 1937); *Federal Reserve Bank v. Smylic*, 134 S.W.2d 838 (Tex. Civ. App. 1939); *May R. Kieferdorf*, 1 T.C. 772 (1943), *aff'd*, 142 F.2d 723 (9th Cir.), *cert. denied*, 323 U.S. 733 (1944). See Part IV.A.4, in the second installment of this article.

72. G.C.M. 22499, 1941-1 CUM. BULL. 272, *relying on* *Wire Wheel Corp. v. Fayette Bank & Trust Co.*, 30 F.2d 318 (7th Cir. 1928).

73. *Contra*, *Southern Ry. v. United States*, 306 F.2d 119 (5th Cir. 1962). In bankruptcy, all are on a parity. Pp. 272-73 *infra*.

74. Insolvency in the "bankruptcy" sense (11 U.S.C. § 1(19) (1964)) is required. *United States v. Oklahoma*, 261 U.S. 253, 259-61 (1923); *United States v. Press Wireless, Inc.*, 187 F. 2d 294 (2d Cir. 1951). *But see* p. 238 *infra*.

75. *United States v. Oklahoma*, 261 U.S. 253 (1923).

76. Plumb, *Federal Tax Collection and Lien Problems*, 13 TAX L. REV. 459, 481 (1958). The reference is not to the familiar attachment made at the instance and for the benefit of one creditor, but to a form which was in use in some states when the federal statute was enacted, by which the absconder's property was sequestered and administered for the benefit of all his creditors. For a modern application, however, see *United States v. Clover Spinning Mills Co.*, 373 F.2d 274, 277 (4th Cir. 1965).

77. 11 U.S.C. § 21(a)(4) (1964); *West Co. v. Lea*, 174 U.S. 590 (1899). Regarding a mortgage to trustees for creditors, for the purpose of rehabilitation, see note 143 *infra*.

ment of a receiver to take charge of the debtor's property at a time when he is insolvent either in the "bankruptcy" sense of insufficiency of assets or in the "equity" sense of being unable to pay his debts as they mature⁷⁸—provided, in either case, that insolvency in the "bankruptcy" sense exists *by the time of distribution*).⁷⁹

Those acts, in general, involve a divestment of the debtor's property, and the Supreme Court therefore has generalized in repeated dicta that the "priority does not attach while the debtor continues the owner and in possession of the property,"⁸⁰ but applies only "when the possession and control of the estate of the insolvent is given to any person charged with the duty of applying it to the payment of the debts of the insolvent, as the rights and priorities of creditors may be made to appear."⁸¹ Thus the application of the federal priority statute has been confined almost exclusively to insolvent decedent estates, general assignments for creditors, general equity receiverships, bankruptcy reorganizations,⁸² state-supervised liquidations of regulated corporations,⁸³ and comparable collective proceedings for the administration or distribution of the assets of an insolvent.

Nevertheless, despite such expressions by the Supreme Court, there is some tendency in the lower courts to apply the insolvency statute where acts of bankruptcy are committed which do not involve or lead to collective proceedings of any kind. Thus, the Government has been allowed to enforce its priority against property fraudulently conveyed

78. 11 U.S.C. § 21(a)(5) (1964). Regarding a receiver of specific property in a mortgage foreclosure, see note 88 *infra*.

79. *Hatch v. Morosco Holding Co.*, 61 F.2d 944 (2d Cir. 1932), *cert. denied*, 288 U.S. 613 (1933); *Davis v. Pullen*, 277 F. 650 (1st Cir. 1922). See *Price v. United States*, 269 U.S. 492, 502 (1926).

80. *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 488 (1926).

81. *Id.* at 490, recently quoted with approval in *King v. United States*, 379 U.S. 329, 336 (1964). See also *United States v. Vermont*, 377 U.S. 351, 354 (1964); *United States v. New Britain*, 347 U.S. 81, 85 (1954) ("where all the property of the debtor is involved, Congress has protected the federal revenues by imposing an absolute priority"); *United States v. Knott*, 298 U.S. 544, 552 (1936) ("the priority statute is not applicable unless insolvency has been manifested by some proceeding equivalent to an assignment of all the debtor's property"); *United States v. Oklahoma*, 261 U.S. 253, 260 (1923).

82. Rev. Stat. § 3466 has been held applicable in that modern counterpart of the equity receivership, a reorganization proceeding under Chapter X of the Bankruptcy Act. *United States v. Anderson*, 334 F.2d 111 (5th Cir. 1964), *cert. denied*, 379 U.S. 879 (1964). Although 11 U.S.C. § 502 (1964) makes the priorities provided in 11 U.S.C. § 104 (Supp. II 1965-66) (which are less federally oriented, see p. 240 *infra*) *inapplicable* under Chapter X, in the absence of a special order, and the only express priority provision in that Chapter relates to taxes (11 U.S.C. § 599 (1964)), the court determined that the Section 3466 priority for other federal claims was incorporated by implication.

83. Although a bank or insurance company is not eligible for bankruptcy (11 U.S.C. § 22(a) (1964)), it can commit an "act of bankruptcy" by going into liquidation, thereby making the insolvency priority applicable. *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 489-90 (1926); *United States v. Knott*, 298 U.S. 544 (1936).

by a debtor and recovered by a judgment creditor.⁸⁴ And the priority statute has been successfully invoked by the Government against preferential transfers by a debtor, even though not followed by a petition in bankruptcy within four months, or at all.⁸⁵ Furthermore, the Government's own action in obtaining a lien by attachment or levy on property of an insolvent debtor has been held, if not duly vacated or discharged, to be an act of bankruptcy triggering the federal priority in the property involved, to the detriment of an existing lienor.⁸⁶ In two cases, undischarged judgment liens by *other* creditors, inferior in rank both to the United States and the competing lienor, were held to constitute acts of bankruptcy, elevating the Government's priority in the property which had been subject to the pre-existing liens.⁸⁷ Presumably the competing lienor's own action in trying to enforce his rights could have similar effect, although apparently not if it went no further than to enforce his existing lien and no lien on other property resulted from "legal proceedings or distraint."⁸⁸

84. *United States v. Mr. Hamburg Bronx Corp.*, 228 F. Supp. 115 (S.D.N.Y. 1964) (in which, as is typical, the court mingles the concepts of insolvency priority and lien priority, but rests more soundly on the priority of the tax lien over the judgment). *But cf.* *United States v. Fidelity & Deposit Co.*, 214 F.2d 565, 570 (5th Cir. 1954), in which the court assumed the applicability of the insolvency priority in a suit to set aside a fraudulent conveyance, but then allowed the creditor who brought the proceeding a lien on the property recovered—a result which (assuming the validity of the first premise) is questionable, since the lien arose out of the very event giving rise to the federal priority. *Cf.* *United States v. Division of Labor Law Enforcement*, 201 F.2d 857 (9th Cir. 1953); *United States v. Oklahoma*, 261 U.S. 253, 260 (1923).

85. *Lakeshore Apartments, Inc. v. United States*, 351 F.2d 349, 353 (9th Cir. 1965) (imposing personal liability under Rev. Stat. § 3467 on corporate managers who made preferential payment); *United States v. Caldwell*, 74 F. Supp. 114 (M.D. Tenn. 1947) (preferential pledge; court rests equally on priority of federal tax lien over the later pledge).

86. *United States v. Menier Hardware No. 1, Inc.*, 219 F. Supp. 448 (W.D. Tex. 1963). Institution of a suit to foreclose a federal tax lien, on the other hand, was held not to be an act of bankruptcy, and hence not to improve the Government's priority position, because the federal lien was not obtained "through legal proceedings or distraint" (as required by 11 U.S.C. § 21(a)(3) (1964)) but existed independently thereof. *United States v. Schroeder*, 204 F. Supp. 199 (S.D. Iowa 1962). However, if the Government enforces its tax lien by levy ("distraint"), rather than by judicial foreclosure, there is authority that the distraint, if not duly vacated or discharged, is an act of bankruptcy (*In re Timberline Lodge*, 139 F. Supp. 13, 15 (D. Ore. 1955)), and thus, under the theory of the *Menier* case, *supra*, might make the federal priority applicable.

87. *W.T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881, 885-86 (4th Cir. 1963); *United States v. Williams*, 139 F. Supp. 94 (M.D.N.C. 1956). In *Foodco*, the district court had found the federal lien (a mortgage) to be prior, and had rested only alternatively on the insolvency priority; but the Fourth Circuit viewed lien priority as irrelevant and rested entirely on the insolvency statute. In *Williams*, the court deemed the competing lien to have priority, of which it was deprived when the act of bankruptcy intervened. While those cases might be deemed to be in direct conflict with *Prince v. Bartlett*, 12 U.S. (8 Cranch) 431 (1814), that case may be explained as having arisen when there was no federal bankruptcy act, so that the suffering of a lien by legal proceedings, while insolvent, was not then defined by law as an act of bankruptcy. The dicta in accord therewith (*see p. 238 supra*), however, have continued into the modern era.

88. *Cf. United States v. Schroeder*, 204 F. Supp. 199 (S.D. Iowa 1962). Although the

3. *Bankruptcy Priorities Contrasted*

If bankruptcy proceedings actually ensue, however, a very different set of priority rules takes over. Although the earliest bankruptcy laws, in harmony with the insolvency statute, gave first priority to the United States,⁸⁹ Congress has repeatedly re-examined the system of priorities in bankruptcy with the objective of establishing a "reasonable classification of claims as entitled to priority because of superior equities."⁹⁰ As a result, like the federal tax lien law, the National Bankruptcy Act has become progressively less federally oriented, with the federal priority yielding to administrative expenses,⁹¹ certain wage claims,⁹² and certain expenses of creditors.⁹³ Federal tax claims enjoy the fourth priority, but they share that priority *on a parity* with state and local tax claims.⁹⁴ Federal non-tax claims, while still ahead of general creditors, enjoy the next lower priority, and thus rank behind state and local taxes and equal to certain rent claims.⁹⁵ The Government's claims for penalties and forfeitures antedating the proceeding, which would be allowed full priority under the insolvency statute,⁹⁶ are not allowable at all in bankruptcy, reflecting the long-standing policy of Congress not to impose the burden of the punishment for the bankrupt's wrongdoing upon his creditors.⁹⁷ Furthermore, in order to prevent the accu-

Supreme Court has expressly held the question open (*Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362, 368-69 (1946)), it is generally considered that a receivership constitutes an act of bankruptcy only if it is general, and that appointment of a receiver in mortgage foreclosure will not suffice (*Elfast v. Lamb*, 111 F.2d 434 (2d Cir. 1940); *Central Fibre Prods. Co. v. Hardin*, 82 F.2d 692 (5th Cir.), *cert. denied*, 299 U.S. 547 (1936); *but cf. United States v. Morrison Indus., Inc.*, 227 F. Supp. 974 (N.D. Ohio 1963)), unless a receivership which began in that fashion is extended and made general, as in *United States v. Texas*, 314 U.S. 480 (1941), or unless the mortgage itself covered all the debtor's property, as in *United States v. Clover Spinning Mills Co.*, 373 F.2d 274 (4th Cir. 1966).

89. See *United States v. Emory*, 314 U.S. 423, 428 (1941).

90. *Carpenter v. Wabash Ry.*, 309 U.S. 23, 28 (1940).

91. 11 U.S.C. § 104(a)(1) (Supp. II, 1965-66). For the history, see *District of Columbia v. Greenbaum*, 223 F.2d 633, 636 (D.C. Cir. 1955). Unlike the rule sometimes applied in insolvency (p. 237 *supra*), all administration expenses, including federal taxes incurred during the proceeding rank equally in bankruptcy. P. 273 *infra*.

92. 11 U.S.C. § 104(a)(2) (Supp. II, 1965-66). For the history, see *United States v. Emory*, 314 U.S. 423, 428 (1941); *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152 (1912).

93. 11 U.S.C. § 104(a)(3) (Supp. II, 1965-66).

94. 11 U.S.C. § 104(a)(4) (Supp. II, 1965-66). See *Missouri v. Ross*, 299 U.S. 72 (1936); *New Jersey v. Anderson*, 203 U.S. 483, 489 (1906).

95. 11 U.S.C. § 104(a)(5) (Supp. II, 1965-66), which incorporates Rev. Stat. § 3466, 31 U.S.C. § 191 (1964), but with very different effect than that which it has in the absence of bankruptcy. See *Small Bus. Adm'n v. McClellan*, 364 U.S. 446, 447 n.5 (1960).

96. *Jobbers Credit Ass'n v. United States*, 164 F. Supp. 22 (E.D.N.Y. 1958), *citing Spokane County v. United States*, 279 U.S. 80 (1929).

97. 11 U.S.C. § 93(j) (1964). Penalties are disallowed even if a lien therefor has arisen before bankruptcy. 11 U.S.C. § 107(c)(4) (Supp. II, 1965-66); *Simonson v. Granquist*, 369 U.S. 38 (1962). "Penalties" which merely make good the Government's pecuniary loss are allowable, however.

mulation of "stale" tax liabilities having priority over general creditors, Congress determined in 1966 that claims for taxes which did not become "legally due and owing . . . within three years preceding bankruptcy" should (with certain exceptions) be denied priority status and should rank on a parity with general creditors.⁹⁸

With some exceptions, pre-existing liens are recognized as valid against the trustee in bankruptcy, and hence against priority creditors (including the United States) claiming through the trustee.⁹⁹ Mechanics' liens, state and local tax liens, and others which might not be deemed "choate" under the standards discussed earlier,¹⁰⁰ may be recognized against the trustee if they are timely perfected after bankruptcy,¹⁰¹ and thus may enjoy a higher priority as against federal claims than they would have if the Government had obtained a lien in the normal course.¹⁰² A security interest which might fail the "choateness" test may also be valid against the trustee.¹⁰³

Federal liens *antedating* bankruptcy compete with other liens and security interests on substantially the same terms as if bankruptcy had not occurred.¹⁰⁴ As against the trustee, however, Congress has recently reaffirmed its policy against secret liens in bankruptcy by prescribing, in effect, that federal taxes shall have lien status only if notice of the lien was duly filed before bankruptcy;¹⁰⁵ if liens are not filed, the federal tax claims are relegated to the priority status they would occupy if unsecured by lien.¹⁰⁶ Furthermore, even a validly filed federal tax lien, so far as it affects personal property which has not been reduced

98. 11 U.S.C. § 104(a)(4) (Supp. II, 1965-66), referring to 11 U.S.C. § 35(a)(1) (Supp. II, 1965-66). See Part II.C.1 *infra*.

99. 11 U.S.C. § 107(b) (Supp. II, 1965-66).

100. Part I *supra*. Although the position of mechanics' liens has been improved by the Federal Tax Lien Act of 1966, that law does not apply where the competing federal lien is other than a tax lien (see Part III.A *infra*); and even as against federal tax liens, mechanics' liens may in some circumstances not enjoy their full state law priority, in the absence of bankruptcy. See p. 232 *supra*.

101. If the steps necessary to perfect the lien against a *bona fide purchaser* are timely taken, even after bankruptcy (11 U.S.C. § 107(c)(1)(B) (Supp. II, 1965-66)), the lien will prevail over the trustee, provided it would have been good against a *judgment creditor* as of the date of bankruptcy. 11 U.S.C. § 110(c) (Supp. II, 1965-66).

102. *In re Knox-Powell-Stockton Co.*, 100 F.2d 979 (9th Cir. 1939). If the federal lien antedates bankruptcy and is valid against the trustee, see *infra*.

103. *Security Mortgage Co. v. Powers*, 278 U.S. 149, 155-56 (1928). Although much (but not all) of the "choateness" problem has been resolved by the Federal Tax Lien Act of 1966 where security interests compete with federal taxes, the "choateness" rule, as we shall see in Part III.A. *infra*, may apply in its pristine form, in the absence of bankruptcy, where the competing federal interest is a mortgage or non-tax lien.

104. *City of Dallas v. United States*, 369 F.2d 645 (5th Cir. 1966).

105. 11 U.S.C. § 110(c)(1) (Supp. II, 1965-66) and 26 U.S.C. § 6323(a) (Supp. II, 1965-66); *United States v. Speers*, 382 U.S. 266 (1965).

106. See pp. 240-41 *supra*.

to possession before bankruptcy, is postponed to payment of administration expenses and preferred wage claims.¹⁰⁷

Congress, for nearly 170 years, has left untouched the insolvency priority statute, while greatly modifying its policies with respect to both bankruptcy priorities and the priority of federal tax liens. Moreover, as a result of the discrepancies between the bankruptcy and insolvency rules, some creditors have a distinct incentive to throw into bankruptcy a debtor whose case might have been handled, with less expense and less burden on the federal courts, in another form of proceeding.¹⁰⁸ In those circumstances where bankruptcy is not an available alternative because the debtor is not eligible—for example, decedent's estates,¹⁰⁹ banks, building and loan associations, and insurance companies¹¹⁰—an unjust discrimination against his creditors results from the application of the more stringent priority rule of Section 3466.

The argument will no doubt be advanced by some lien creditors that the policies which Congress expressed in the Federal Tax Lien Act of 1966¹¹¹ should be considered incorporated by implication into the general insolvency priority statute. Like reasoning led a number of lower courts to hold, under earlier law, that the mortgagees, pledgees and judgment creditors whom Congress then protected against federal tax liens could not have been intended to be subordinated when insolvency ensues.¹¹² The Supreme Court, however, has been unwilling to find an implied amendment of the insolvency statute, even by changes in the Bankruptcy Act (which is more *in pari materia* than the tax lien law).¹¹³ And the Court has also recently made clear that the insolvency priority

107. 11 U.S.C. § 107(c)(3) (Supp. II, 1965-66); *Jordan v. Hamlett*, 312 F.2d 121 (5th Cir. 1963). See Seligson, *Treatment of Statutory Liens in Bankruptcy—The 1966 Amendments of Section 67b and c*, 27 FED. B.J. 111 (1967).

108. The relative advantages to creditors are detailed in W. PLUMB & L. WRIGHT, *supra* note 3, ch. 6.

109. *In re Estate of Hiller*, 240 F. Supp. 504 (N.D. Cal. 1965); *In re Fackelman*, 248 F. 565 (S.D. Cal. 1918); cf. *Harris v. Zion's Sav. Bank & Trust Co.*, 317 U.S. 447 (1943). If bankruptcy proceedings were commenced before death, they do not abate. 11 U.S.C. § 26 (1964).

110. 11 U.S.C. § 22(a) (1964).

111. See Part I *supra*.

112. *Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 246 F.2d 141 (5th Cir. 1957); *Evans v. Stewart*, 245 Iowa 1268, 66 N.W.2d 442 (1954) (mortgages); *In re Estate of Decker*, 355 Pa. 331, 49 A.2d 714 (1946), *cert. denied*, 331 U.S. 807 (1947) (pledgee); *Muniz v. United States*, 129 Ind. App. 433, 155 N.E.2d 140 (1958); *In re Estate of Meyer*, 159 Pa. Super. 296, 48 A.2d 210 (1946) (judgments). But see *Kentucky v. United States*, 67-2 U.S. Tax Cas. ¶ 9664 (6th Cir. 1967).

113. *United States v. Emory*, 314 U.S. 423 (1941). The discrepancies between the two statutes are said to have resulted from "a process of legislation in compartments, curiously myopic." Rogge, *The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships*, 43 HARV. L. REV. 251 (1929).

and the tax lien priority (before the 1966 amendments) are not governed by the same standards.¹¹⁴ It is a fair inference, therefore, that uniformity of treatment must be sought not from the judiciary but from Congress.

4. *Reform*

The legislation originally recommended by the American Bar Association included an amendment to Section 3466 of the Revised Statutes designed to coordinate the federal priority in insolvency, with both the general priority policies developed in the Bankruptcy Act and the relief proposed for certain security interests and liens as against the federal tax lien. Unfortunately, because the insolvency statute affects many federal claims in addition to tax claims, the proposal fell outside the jurisdiction of the congressional committees which considered the Federal Tax Lien Act of 1966, and the insolvency amendment was, therefore, omitted from the legislation which finally evolved. The time is now ripe for the Bar to bring that portion of its proposal before the appropriate committees of Congress.¹¹⁵ However, because Congress appears to have taken no "hard look" at the insolvency priority statute in 170 years, some basic re-examination of the policy of the statute may be in order, going beyond the somewhat narrowly focused recommendation heretofore put forward by the Bar.

(a) *General Policy; Debts Entitled to Priority*

The attitude of Congress and the courts toward federal priorities has varied from generation to generation. As Justice Holmes wrote for a unanimous Court in 1925, "There is no doubt an intermittent tendency on the part of governments to be a little less grasping than they have been in the past . . .,"¹¹⁶ and "Public opinion as to the peculiar rights and preferences due to the sovereign has changed."¹¹⁷ The second of these statements was made in a case which interpreted the Bankruptcy Act of 1898 as having relinquished the federal right of priority, in

114. *United States v. Vermont*, 377 U.S. 351, 358 (1964). *But cf.* *United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 51 (1950).

115. *See Report of the Special Committee on Federal Liens*, 84 A.B.A. REP. 645, 731 (1959) [hereinafter cited as 84 A.B.A. REP.]. The National Bankruptcy Conference has now appointed a committee to study the amendment of Rev. Stat. § 3466.

116. *White v. Mechanics Sec. Corp.*, 269 U.S. 283, 301 (1925).

117. *Davis v. Pringle*, 268 U.S. 315, 318 (1925). Both statements were quoted with approval in *National City Bank v. Republic of China*, 348 U.S. 356 (1955), in support of the view that the sovereign immunity from suit had not been "favored by the test of time," but had "increasingly been found to be in conflict with the growing subjection of governmental action to moral judgment." *Id.* at 359.

bankruptcy only, for all claims other than taxes.¹¹⁸ Unfortunately, as was so often the case, Justice Holmes was running ahead of public opinion, or at least of congressional opinion, for Congress overturned his decision a year later.¹¹⁹ And the federal courts themselves were shortly to embark on their 37-year course of roughshod extension of federal priorities.¹²⁰ The unanimous action of Congress in adopting the Federal Tax Lien Act of 1966, however, gives ground for the hope that "public opinion" once more has changed, and that Congress would now be receptive to imposing reasonable restraints on the federal priority.

Section 3466 was enacted in 1797 and during much of our subsequent history federal taxes were relatively low and federal contract claims were a relatively minor factor.¹²¹ It was then not too much to ask of business, in extending credit, to take into account the prospect that a moderate amount of federal claims would have priority over private claims if their debtors failed. Today, when even a failing business may incur enormous federal tax obligations unrelated to profits, and when many marginal debtors are financed under the extensive federal loan and guarantee programs, the federal priority can very often mean the difference between a reduced recovery and no recovery at all. The Government, drawing its revenue from the entire population, is in a better position to self-insure its risks than are private parties, for some of whom the failure of even a single major debtor may be ruinous. It is hardly sound government policy to attempt to bolster the economy by federal loans and guarantees, and at the same time to discourage uninsured credit by making it more hazardous.¹²²

118. *Davis v. Pringle*, 268 U.S. 315 (1925). See also *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152 (1912). The antecedent of present 11 U.S.C. § 104(a)(5) (Supp. II, 1965-66) then provided fifth priority for "debts owing to any person who by the laws of the states or the United States is entitled to priority." Act of July 1, 1898, ch. 541, § 64(b)(5), 30 Stat. 563. The United States was held not to be a "person," and hence Rev. Stat. § 3466 was held not to have been incorporated thereby.

119. The Act of May 27, 1926, ch. 406, § 15(b)(7), 44 Stat. 666, added a proviso to the language quoted *supra* note 118, making clear that the United States was a "person" entitled to fifth priority for its non-tax debts. The amendment was a House addition to a Senate-passed bill, and was apparently regarded as either so self-evident or so unimportant that it was not mentioned either in the Committee report or in debate. H.R. REP. NO. 887, 69th Cong., 1st Sess. 5, 10 (1926); 67 CONG. REC. 7671-80 (1926).

120. See Kennedy, *From Spokane County to Vermont: The Campaign of the Federal Government against the Inchoate Lien*, 50 IOWA L. REV. 724 (1965).

121. "At that time [1797], the taxes imposed by the United States were few and light; the number who paid them were not many; and the income tax had not been thought of. Times have changed, and congressional reappraisal of the 'wisdom and justice' of this statute would seem to be in order." *Estate of Shoptaw*, 54 Wash. 2d 602, 607, 343 P.2d 740, 743 (1959). See also *Muniz v. United States*, 129 Ind. App. 433, 450, 155 N.E.2d 140, 148 (1958).

122. See MacLachlan, *Improving the Law of Federal Liens and Priorities*, 1 B.C. IND.

It is probably too much to expect that Congress would completely abandon its priority, at least as it applies to tax claims, for which the Government has no choice of debtors.¹²³ The priority has been reviewed, in the bankruptcy context, too often and too recently to hope for anything more than reasonable limitation. It is not too much to ask, however, that Congress extend to non-bankruptcy insolvencies the bankruptcy principle that tax penalties (as well as other penalties and forfeitures) should not be allowed at the expense of innocent creditors of the insolvent wrongdoer.¹²⁴ Furthermore, Congress should consider extending to non-bankruptcy insolvencies the principle, adopted for bankruptcy cases in 1966, that creditors should not be burdened with excessive accumulation of taxes enjoying priority, and that taxes which "became legally due and owing" more than three years before the proceeding should, therefore, stand only on a parity with general creditors.¹²⁵

Congress ought also to consider terminating, in both insolvency and bankruptcy, the federal priority as it applies to claims for *other than taxes*.¹²⁶ As the Fourth Circuit said of the Bankruptcy Act of 1898, which had that effect:

No sound principle of public policy can be invoked in support of preference to the federal government and to the states over citizens in the collection of ordinary debts. On the contrary, the contractual operations of the federal government and of the states have become so extensive and so involved with the business of private citizens that priority to the federal government and to the states,

& COM. L. REV. 73, 74-76 (1959); Plumb, *What Ever Happened to the A.B.A. Federal Tax Lien Legislation?* 18 BUS. LAW 1103, 1103-1104 (1963).

123. See 63 MICH. L. REV. 944, 949 (1965).

124. P. 240 *supra*. It is of interest that the Supreme Court, on its own motion, has extended to non-bankruptcy insolvencies the comparable, but unwritten, principle of bankruptcy law (*City of New York v. Saper*, 336 U.S. 328 (1949)) that interest on taxes does not run against the insolvent estate during the proceeding. *United States v. Bloom*, 342 U.S. 912 (1952), *aff'g mem. In re Pavone Textile Corp.*, 302 N.Y. 206, 97 N.E.2d 775 (1951). A similar recommendation with respect to penalties was made in *Rogge*, *supra* note 113, at 277, but it was confined to insolvencies administered in the federal courts. In state-supervised proceedings, the author's view was that Congress had power to provide for the disallowance only of federal penalties; as to state and private penalties, he would have Congress merely subordinate them to the federal priority. *Cf.* notes 159-61 *infra*.

125. 11 U.S.C. § 104(a)(4) (Supp. II, 1965-1966), *referring to* 11 U.S.C. § 35(a)(1) (Supp. II, 1965-1966). See p. 253 *infra*, for discussion of whether state and local taxes should be placed on a parity with federal taxes in this respect (as they are under the Bankruptcy Act).

126. This suggestion goes beyond the American Bar Association recommendation, which would have left the priority applicable to any "claims which, from their inception, were owed to or insured or guaranteed by the United States." 84 A.B.A. REP. 732 (1959). The ABA Special Committee made no study of the desirability of further limiting the priority in this respect.

except for taxes, would operate as an oppressive hardship on other creditors of bankrupts.¹²⁷

In such activities, unlike tax collection, the Government is able to choose its debtors and to exact such security as the circumstances and congressional policy may require, so it does not have the same need for the added protection of sovereign priority.¹²⁸ A federal loan guarantee program, in which the guarantor agency is indemnified by a right of first priority, simply transfers the risk of loss from the protected creditor to the less favored, uninsured creditors of the debtor, with resulting inequity. Furthermore—equitable considerations aside—the tremendous expansion of federal loans, guarantees, and other financial operations in the four decades since the federal priority for non-tax claims was restored by Congress in 1926 makes it appropriate to raise once again the question whether it is good for the economy to have such priority claims hanging as a threat over unsecured credit.¹²⁹

If, however, the priority of such non-tax federal claims is to be maintained, consideration should be given to bringing about some consistency and uniformity in the application of the rules, even though it means some expansion of the priority. As the law stands, if a government agency insures or guarantees a loan, and the obligation on default is assigned to the United States before bankruptcy or insolvency occurs,

127. *Davis v. Pringle*, 1 F.2d 860, 864 (4th Cir. 1924), *aff'd*, 268 U.S. 315 (1925). *Accord*, G. GLENN, *LIQUIDATION* § 511 (1935).

128. 63 MICH. L. REV. 944, 948-49 (1965). The precedents in the English common law and the state decisions are reviewed extensively in *United States Fidelity & Guar. Co. v. Carter*, 161 Va. 381, 170 S.E. 764 (1933), which concludes that, although the priority of the English crown had extended to contract claims as well as taxes, the majority of the states, which inherited the priority rule as a part of the common law, had rejected its application to contract claims as smacking so much of royal prerogative that it was inappropriate to our society. *Id.* at 403, 170 S.E. at 772. Since 1947 England has limited the priority to obligations arising from "public acts." See Salter, *Priority Accorded the Sovereign in Bankruptcy: The American and British Views*, 63 COM. L.J. 354 (1958).

129. See Comment, *The Relative Priority of Small Business Administration Liens: An Unreasonable Extension of Federal Preference?*, 64 MICH. L. REV. 1107, 1118-23 (1966). Heretofore, Congress has relinquished the benefit of the insolvency priority in the case of the "regular lending operations," but not the "wartime activities," of the Reconstruction Finance Corporation. 15 U.S.C. § 603 (1964); *In re Temple*, 174 F.2d 145 (7th Cir. 1949). Yet Congress has expressly endowed the Commodity Credit Corporation with the benefit of the priority, 15 U.S.C. § 714b(e) (1964), and the Supreme Court has refused, given the silence of Congress, to imply an intent to relinquish the priority for such unincorporated financing agencies as the Small Business Administration, the Farm Credit Administration, and the Federal Housing Administration. *Small Bus. Adm'n v. McClellan*, 364 U.S. 446 (1960); *U.S. Dept. of Agriculture v. Remond*, 330 U.S. 539 (1947); *United States v. Emory*, 314 U.S. 423 (1941). An abortive effort to deny the priority to the Small Business Administration is recounted in Comment, *supra*, at 1115-16. In an earlier day, the purpose of Congress to make credit available to meet pressing needs was held incompatible with an intent to maintain a priority which would tend to restrict the availability of other credit. *United States v. Guaranty Trust Co.*, 280 U.S. 478 (1930).

the applicable federal priority is given effect.¹³⁰ If the assignment of the defaulted claim is delayed until after that event, however, the Government is not regarded as the creditor but must prove its claim in the right of, and with only the priority enjoyed by, the primary obligee.¹³¹ On the other hand, if the Government's protection of the creditor takes the form of a percentage "participation" in the loan—say, a 75 per cent interest, with an agreement to share any loss ratably with the private lender—the right of priority attaches to the Government's equitable interest from the outset, even though formal assignment of the obligation occurs only after bankruptcy or insolvency; and the priority then applies to the full 75 per cent participation, even though 25 per cent of the 75 per cent recovered under the priority (*i.e.*, 18¾ per cent of the debt) will be paid over by the Government to the lender under the loss-sharing agreement.¹³² The Government's exposure to loss is the same in all such cases, whether at the moment of bankruptcy or insolvency it stands as legal or beneficial owner of the claim or is still merely an insurer or guarantor. If the principle of applying the federal priority in any such situations is sound, it is equally appropriate in all of them, and the Government should always be permitted to prove its assignment as a priority claim in bankruptcy or insolvency.¹³³

Further, if the federal priority is to be maintained at all in such cases, it should at least be conditioned upon the recording of some evidence of the federal participation in or guarantee of obligations which are ostensibly held by private creditors, in order that subsequent creditors, relying upon the position they would occupy under state law

130. *United States v. Emory*, 314 U.S. 423 (1941).

131. *United States v. Marxen*, 307 U.S. 200 (1939). The *Marxen* case left open whether the Government might prove an independent (priority) claim on the debtor's implied (or express) promise to indemnify the federal guarantor. But such independent proof has been held precluded, at least in bankruptcy, by the principle against double proof, embodied in 11 U.S.C. § 93(i) (1964). *In re Miller*, 105 F.2d 926, 929 (2d Cir. 1939); *cf. Bulls v. United States*, 356 F.2d 619, 623 (5th Cir. 1966) (a receivership case). The *Marxen* rule was held inapplicable in a Chapter X reorganization, by virtue of 11 U.S.C. § 601 (1964), so claims assigned to the United States during the proceeding enjoy priority. *United States v. Anderson*, 334 F.2d 111 (5th Cir.), *cert. denied*, 379 U.S. 879 (1964).

132. *Small Bus. Adm'n v. McClellan*, 364 U.S. 446 (1960). In Comment, *supra* note 129, at 1133, it is recommended that the Small Business Administration be prohibited from contracting away a portion of its preferred recovery and thus indirectly allowing a private creditor the use of the federal priority. It is difficult, however, to see the difference between that practice and the Federal Housing Administration's paying off a guaranteed loan and then availing of its priority to reimburse itself. If one is bad, both are bad; if one is approved, the other cannot be condemned.

133. The American Bar Association proposal would have left the existing rule on this matter in effect. 84 A.B.A. REP. 732, 734 (1959).

if the Government were not involved, may not be entrapped into extending credit.¹³⁴

In addition, there appears to be no justification for elevating the priority of a private debt, never insured or guaranteed by the Government, just because the Government levies upon or takes an assignment of the obligation in satisfaction of a claim of its own *against a creditor* of the insolvent or bankrupt. Suppose, for example, that debtor A has assets of \$100,000 and debts of \$1,000,000, of which \$100,000 is owed to creditor B, who in turn owes \$100,000 to the federal tax collector or to a federal lending agency. If, before bankruptcy or before an insolvency proceeding is instituted, the tax collector levies on B's claim against A, or B assigns the claim to the lending agency, the claim—which in B's hands had been worth only \$10,000 (10 cents on the dollar)—becomes worth its face value and thus satisfies B's entire \$100,000 obligation to the Government; and the other creditors, who had no dealings with the Government's debtor (B) at all, but who happened to be creditors of the same debtor of B, will recover nothing.¹³⁵ The Government has even argued, unsuccessfully to date, that the mere existence of a federal tax lien on the creditor's assets, with no levy or other act to appropriate a particular obligation to the federal claim, is enough to make the Government the "owner" of the obligation and to make the federal priority applicable.¹³⁶ The American Bar Associ-

134. In *W. T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963), a mortgage in which a bank appeared of record as the only party interested was, after foreclosure of a mechanic's lien commenced, assigned to the United States pursuant to a "participation" of the Small Business Administration, thereby defeating the superpriority to which the mechanic's lien was entitled (as against pre-existing mortgages on the improvements) under state law. For further discussion of the inequity involved see Comment, *supra* note 129, at 1120-21, 1133.

135. In *re Cherry Valley Homes*, 255 F.2d 706 (3d Cir. 1958), *cert. denied sub nom. DuBois v. United States*, 358 U.S. 864 (1958) (insolvency; levy for taxes); In *re Cal-Neva Lodge, Inc.*, 186 F. Supp. 187 (D. Nev. 1960) (bankruptcy; levy for taxes); In *re Deputy Construction Co.*, 58-1 U.S. Tax Cas. ¶ 9468 (D. Del. 1957) (bankruptcy; assignment of claim); cf. *Engleman v. Commodity Credit Corp.*, 107 F. Supp. 930 (S.D.N.Y. 1952) (claim assigned to secure federal debt; priority denied because assignment occurred after assignor's debtor had made general assignment for creditors, thereby freezing the priority status of claims against him).

136. *United States v. Exchange Nat'l Bank of Olean*, 217 F. Supp. 287 (W.D.N.Y. 1963). On the other hand, under the early English law, as reviewed in *United States Fidelity & Guar. Co. v. Carter*, 161 Va. 381, 390, 170 S.E. 764, 767 (1933), the priority "extended to a debt due the debtor of a debtor of the king's debtor, and so on to any number of degrees," and "upon a plaintiff's suggesting that he was indebted to the king, he was given the same right of priority over creditors of his debtor that the king would have been entitled to if the king had seized the debt for satisfaction of his debt"—a principle that was so abused that it was "practically abolished" in England in 1817. In other contexts, the American cases are in disagreement about whether the mere existence of a federal lien makes the Government the "owner" of a debt owing to the taxpayer, or whether a levy is necessary. See W. PLUMB & L. WRIGHT, *supra* note 3, ch. 9, § 1.

ation recommended, on the other hand, that the priority be made inapplicable to all such claims, whether assigned, levied upon, or subjected to lien.¹³⁷

(b) *Confining the Priority to Collective Proceedings*

A statutory rule of priority creating no lien but providing the order of distribution of assets is appropriately applicable only in collective proceedings involving all, or substantially all, of a debtor's assets.¹³⁸ Although the Supreme Court has recognized this, the awkward and partially obsolete language of Section 3346¹³⁹ has led some courts to apply it like a rule of lien priority in suits where only particular assets were involved.¹⁴⁰ The American Bar Association proposal would confine the priority statute to its proper function by revising it to read, in part, as follows:

When an insolvent debtor of the United States is divested of the title or possession, or both title and possession, of all or substantially all of his property for the purpose of effecting general administration for the benefit of creditors otherwise than in bankruptcy, or when the estate of a deceased debtor of the United States is insolvent, the claims of the United States shall be entitled to priority of payment, subject to the following qualifications: . . .¹⁴¹

The recommendation, in line with court decisions, further provided that

A debtor shall be deemed insolvent whenever his property which is subject to general administration for the benefit of creditors . . . is insufficient, either at the commencement of the proceedings or during pendency thereof, to pay all his debts.¹⁴²

The question whether a general receivership or other collective proceeding technically constituted an act of bankruptcy would no longer be of significance; it would be enough that the assets were under general administration and that, at its conclusion, there was not enough

137. 84 A.B.A. REP. 734-35 (1959). The comment of the court in *Cape May County Sav. & Loan Ass'n v. Sebastian*, 93 N.J. Super. 77, 224 A.2d 703 (1966), on a related question, which is quoted note 367 *infra*, is particularly pertinent here.

138. See *United States v. Clark*, 25 F. Cas. 447, 450 (No. 14,807) (C.C.N.Y. 1826).

139. Quoted note 44 *supra*.

140. See pp. 238-39 *supra*.

141. 84 A.B.A. REP. 731 (1959). The language is based on a draft proposed in Kennedy, *The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien*, 63 YALE L.J. 905, 932-33 (1954).

142. 84 A.B.A. REP. 732 (1959). Prof. Kennedy's draft did not include such a provision, and hence might be construed to overturn the decisions, note 79 *supra*, which made it unnecessary to show insolvency existing at the time of divestment.

to go around. In addition, the recommendation would eliminate one anomalous haven from the priority statute by expressly embracing a mortgage for the benefit of creditors given to a trustee for the purpose of rehabilitating the debtor, whenever the ultimate outcome of the proceeding is insolvency and liquidation.¹⁴³

The practical effect of those provisions would appear to be to eliminate proof of insolvency as a prerequisite to the priority.¹⁴⁴ If the assets are sufficient at the termination of the proceeding, no question of priority will arise;¹⁴⁵ if insufficient, insolvency at that time is *ipso facto* established. If the specific requirement of insolvency serves any purpose, it is in untying the hands of the fiduciary during the interval before the situation becomes hopeless;¹⁴⁶ but that purpose might better be served by limiting the personal liability of the fiduciary who pays other debts before insolvency occurs, as discussed below.¹⁴⁷ The requirement might well be dropped from Section 3466 itself.

(c) *Recognition of Liens in Insolvency Proceedings*

The ancient sovereign priority of the Crown, which affords the precedent for, although not the legal origin of, the federal priority,¹⁴⁸ applied only to the unencumbered assets of the debtor, and was subject to specific liens and encumbrances existing before the sovereign sought to enforce his right.¹⁴⁹ In bankruptcy, as we have seen, the trustee takes subject to most pre-existing liens, including some that might be regarded as "inchoate" at the time of bankruptcy, and such liens, there-

143. *Id.*: "An assignment, mortgage, or pledge of all or substantially all of the property of a debtor for the purpose of effecting general administration for the benefit of creditors shall be deemed a divestment for purposes of this section, whether or not provision is made for a reversion to the debtor." Under present law, the giving of the mortgage is not considered an assignment for creditors, and hence there is no act of bankruptcy, because rehabilitation rather than liquidation is contemplated and a reversion to the debtor is provided. *United States v. Gargill*, 218 F.2d 556 (1st Cir. 1955). Hence, the insolvency priority statute is held inapplicable. *Intermountain Ass'n of Credit Men v. Bush*, 14 Utah 2d 389, 384 P.2d 808 (1963); *Smith v. United States*, 113 F. Supp. 702 (D. Hawaii 1953). *But cf.* Rev. Rul. 56-592, 1956-2 CUM. BULL. 945. If there is no realistic equity of redemption, however, the transaction is construed as a general assignment. *Wing v. United States*, 208 F. Supp. 5 (D. Mass. 1962).

144. Failure to establish insolvency, in the sense of insufficiency of assets to pay debts, caused the Court to refuse to order priority of payment to the Government in *United States v. Oklahoma*, 261 U.S. 253 (1923).

145. See *Davis v. Pullen*, 277 F. 650, 654 (1st Cir. 1922) ("Of course, if it had turned out to be in fact solvent, as it was alleged to be, no question of priority would have arisen.")

146. *United States v. Middle States Oil Corp.*, 18 F.2d 231 (8th Cir. 1927); *cf.* *United States v. Lutz*, 295 F.2d 736 (5th Cir. 1961).

147. See p. 256 *infra*.

148. *United States v. State Bank of North Carolina*, 31 U.S. (6 Pet.) 29, 35 (1832).

149. *Marshall v. New York*, 254 U.S. 380, 382 (1920); *In re Gruner*, 295 N.Y. 510, 524, 68 N.E.2d 514, 522 (1946). See Kennedy, note 141 *supra*, at 905, 907.

fore, prevail over the priority provided for federal claims that had not themselves become valid liens before bankruptcy.¹⁵⁰ Only in non-bankruptcy insolvencies—and then only in the judicial interpretations of the past 38 years¹⁵¹—is the security of existing liens (and perhaps also of mortgages) overridden by the federal priority. There is no visible explanation or excuse, other than long years of neglect of the insolvency statute, for giving a higher priority to federal claims merely because the debtor's assets are administered in one form of proceeding rather than another.

Accordingly, the American Bar Association proposal provided:

. . . nothing herein shall impair any lien in favor of the United States existing at the time of divestment of the debtor's property in the manner provided in this section, *nor any other valid lien or security interest which would have been entitled to priority over the claim of the United States immediately preceding such divestment.*¹⁵²

The italicized portion of that proposal may have been too narrowly focused. In effect, it treats the Government, for priority purposes only, as if it had obtained a lien at the time of divestment, and applies the applicable lien priority rules—thereby coordinating the insolvency priority with the newly liberalized federal tax lien provisions, where tax claims are involved, but leaving some antediluvian rules in effect with respect to other federal claims.¹⁵³ It may fairly be argued that the point of reference should be, not the tax lien priority rules, but the bankruptcy principles, under which certain liens are preferred which would be inferior to federal claims if no collective proceedings had occurred before the latter became liens.¹⁵⁴

(d) *Priorities Among Unsecured Claims*

The American Bar Association further recommended that Congress consent to the priority of certain unsecured claims over federal taxes

150. See p. 241 *supra*.

151. See Kennedy, *supra* notes 120, 141.

152. 84 A.B.A. REP. 732 (1959) (emphasis added). In harmony with the bankruptcy provision, 11 U.S.C. § 107 (c)(1)(A), (Supp. II, 1965-66), it would be further provided that "The term 'lien' shall not include any lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor."

153. See Part IIIA *infra*. The reforms proposed therein would, of course, in conjunction with the above proposed amendment of Rev. Stat. § 3466, tend to meet this problem.

154. See pp. 250-51 *supra*. Prof. Kennedy's draft, in Kennedy, *supra* note 141, provided that "Except as provided in Section II [see note 172 *infra*], nothing herein shall impair any valid lien acquired before such divestment." It may be that "valid lien" needs definition, along the lines of 11 U.S.C. § 107, so far as appropriate.

which had not become liens,¹⁵⁵ a proposal which would make the "beneficent" policy of Congress¹⁵⁶ in granting priorities in recognition of "superior equities"¹⁵⁷ applicable without regard to the particular form of the collective proceeding. In its purpose, the Bar proposal was in harmony with one made earlier by Professor Kennedy,¹⁵⁸ but the approach was different. A comparison may be helpful to further study of the matter.

Prof. Kennedy's draft would provide that, next after valid liens, administration expenses "shall be a first charge against the property administered"; that certain wage claims (not exceeding the amount and period prescribed for priority in bankruptcy) "shall be paid before the claims of the United States"; that state and local taxes "shall be accorded equal priority" with federal taxes and "shall be paid before any claims of the United States for other than taxes"; and that claims for rent (limited as in bankruptcy) "shall, if entitled to priority under state law, be accorded equal priority with claims of the United States for other than taxes." Thus, his proposal is that, except in the case of rent, the hierarchy of priorities even among non-federal claims would be prescribed by federal law.

Although Congress, under its power "to establish . . . uniform laws on the subject of bankruptcies throughout the United States,"¹⁵⁹ could probably prescribe the order of priorities in insolvency proceedings otherwise governed by state laws,¹⁶⁰ the Bar took a more permissive approach. Cognizant of the infinite variety of relative priorities among non-federal claims as provided by state laws, and hesitant to have Congress interfere in proceedings (especially the administration of decedents' estates) traditionally regulated by the states,¹⁶¹ the Bar draft

155. 84 A.B.A. REP. 731-34 (1959).

156. *Guarantee Title & Trust Co. v. Title Guar. & Sur. Co.*, 224 U.S. 152, 160 (1912), with reference to wage priorities. "It is . . . socially desirable that the claims of the wage earner who is normally entirely dependent upon his wages for the necessity of life should be paid to the extent of the restriction in section 64a(2) [11 U.S.C. § 104(a)(2)] before the estate is subject to the heavy burden of all tax liens." H.R. REP. NO. 686, 89TH CONG., 1ST SESS. 7 (1965).

157. See *Carpenter v. Wabash Ry.*, 309 U.S. 23, 28 (1940).

158. Kennedy, *supra* note 141, at 933.

159. U.S. CONST. art. I, § 8, cl. 4.

160. The bankruptcy power is not confined to proceedings in which a discharge of the debtor is provided. *Wright v. Union Central Life Ins. Co.*, 304 U.S. 502, 512-14 (1938). And Congress may elect to prescribe uniform rules for only certain aspects of a proceeding, leaving state laws otherwise in effect. *Stellwagen v. Clum*, 245 U.S. 605, 613 (1918).

161. See, e.g., *Harris v. Zion's Sav. Bank & Trust Co.*, 317 U.S. 447, 450 (1943) ("When we reflect that the settlement and distribution of decedents' estates, and the right to succeed to the ownership of realty and personalty are peculiarly matters of state law; that the federal courts have no probate jurisdiction and have sedulously refrained, even in diversity cases, from interfering with that jurisdiction, . . .").

would provide merely for the *consent* of Congress that certain items—conforming, as in Prof. Kennedy's draft, to the bankruptcy priorities—be paid before or on a parity with federal claims, if state law so provided.¹⁶²

The Bar draft would remove any doubt that, in insolvency cases, federal, state and local taxes incurred during the proceeding could enjoy the priority status of administration expenses. And, by treating administration expenses as a single priority class as they are in bankruptcy, it would be implicit—although perhaps it should be expressed—that all are to stand on a parity if the estate is insufficient for their full payment.¹⁶³ It would also provide that funeral expenses might have priority “to the extent that they are allowed by any court having jurisdiction thereof and have priority under applicable state law.”¹⁶⁴ The proposal is silent concerning the priority of allowances for the support of widows and children,¹⁶⁵ as well as concerning the expenses of a decedent's last illness, for the recognition of which a strong plea has been made.¹⁶⁶

The proposal would permit state and local taxes to be paid on a parity with federal taxes in non-bankruptcy insolvency, and would also eliminate the anomaly by which District of Columbia sales taxes now enjoy a higher priority than federal taxes in insolvency, although not in bankruptcy.¹⁶⁷ Both the Bar proposal and the Kennedy draft are silent concerning the limitation of the priority in insolvency of taxes which “became legally due and owing” within three years before the proceeding, a feature which did not enter the Bankruptcy Act until 1966. If, as heretofore suggested,¹⁶⁸ such limitation of the priority is to be incorporated into Section 3466, Congress will probably insist that it be made applicable (as in bankruptcy) to state and local as well as federal taxes. That might be accomplished, under the permissive approach, by consenting to such limitation of the federal tax priority only upon

162. 84 A.B.A. REP. 733 (1959).

163. Cf. authorities cited notes 69, 72, 73 and 91 *supra*.

164. 84 A.B.A. REP. 732, 734 (1959). This provision has no counterpart in bankruptcy, but conforms to existing decisions involving insolvent decedents' estates. Cases cited note 70 *supra*.

165. See the recommendation made in Part IV.A.4, in the second installment of this article. For the present law, see authorities cited note 71 *supra*.

166. *In re Estate of Shoptaw*, 54 Wash. 2d 602, 343 P.2d 740 (1959) (“it would be unfortunate indeed if a man in his last illness could not be attended by a physician, . . . without any assurance that the doctor . . . would be paid”).

167. 84 A.B.A. REP. 735 (1959). For cases holding that D.C. sales taxes enjoy higher priority than federal taxes in insolvency, see cases cited note 67 *supra*.

168. See p. 245 *supra*.

the condition that state law similarly limit state and local tax priorities; or Congress might assert its authority in this respect and impose the restriction on taxes of all kinds.

The Bar proposal would confine the application of those priority rules to those federal taxes which had not become liens at the time of divestment of the debtor's property. It did not attempt to work into the insolvency statute any provision postponing non-possessory tax liens to administration expenses and preferred wage claims, since the corresponding bankruptcy provision¹⁶⁹ was then the center of controversy and its ultimate form was in doubt.¹⁷⁰ Also, the proposal imposed no requirement that notice of the tax lien be filed before the insolvency proceeding in order to enjoy lien status. In bankruptcy, in the face of prolonged and determined Government opposition, those matters were finally resolved adversely to the tax lien by the 1966 amendments to the Bankruptcy Act.¹⁷¹ Before the incorporation of like changes into Section 3466 is recommended, however, consideration should be given to whether the need for such treatment of liens in non-bankruptcy insolvency proceedings is sufficient to warrant the risk of thereby scuttling or long delaying the entire reform proposal.¹⁷²

B. *The Fiduciary's Personal Liability*

Since 1799, without material change, the law has imposed *personal liability* upon "[e]very executor, administrator, or assignee, or other person who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate."¹⁷³ That provision, now Section 3467 of the Revised Statutes, originated in the

169. 11 U.S.C. § 107(c)(3) (Supp. II, 1965-1966).

170. See MacLachlan, *Secured and Prior Claims in Bankruptcy*, 13 BUS. LAW. 128 (1957); Kennedy, *The Bankruptcy Amendments of 1966*, REF. J. 5, 9 (Jan. 1967), reprinted in 1 GA. L. REV. 149, 160-61 (1967).

171. Authorities cited notes 105-07 *supra*.

172. It may be that there is little need or justification for such provisions in the insolvency context. The administration of decedents' estates (the principal category involved) occurs without volition on the part of creditors, so there is less reason for requiring prior filing of the lien than there may be in bankruptcy. Postponement of unenforced tax liens on personal property to administration expenses has already been accomplished without amendment of Section 3466, at least in some (perhaps questionable) decisions. *In re Gilbert Associates*, 97 N.H. 411, 417, 90 A.2d 499, 503-04 (1952), *rev'd on other grounds*, 345 U.S. 361 (1953); cf. *Southern Ry. v. United States*, 306 F.2d 119, 126-27 (5th Cir. 1962); *In re Holmes Mfg. Co.*, 19 F.2d 239 (D. Conn. 1927). Any additional benefits of incorporating the bankruptcy principles in these respects may not be worth the risks of the battle.

173. Rev. Stat. § 3467, 31 U.S.C. § 192 (1964), which originated in the Act of March 2, 1799, ch. 22, § 65, 1 STAT. 676. An amendment by the Revenue Act of 1934, ch. 227, tit. III, § 518, 48 Stat. 760, made clear that the fiduciary's liability for federal debts should not exceed the amount he improperly paid to other creditors.

same statutory section—in fact, in the same sentence—as the predecessor of Section 3466. The Supreme Court has stated that the subsequent division of the provision into two sections of the Revised Statutes “did not work any change in the purpose or meaning,” and that they “must be interpreted *in pari material*.”¹⁷⁴ It is evident, therefore, that the proper and intended function of Section 3467 is to serve as “policeman” for Section 3466, by permitting the Government to recoup from the fiduciaries administering insolvent estates when they injure the Government by disregarding its priority.¹⁷⁵

The liability imposed by Section 3467 may be incurred without reference to whether the fiduciary himself enjoys any personal benefit from the improper payment. It has been said, therefore, that the “severity of these provisions imposes a corresponding obligation to apply them only in the clearest and most unmistakable reading of their precise terms.”¹⁷⁶ Standing by itself, however, the provision might be construed to impose such liability on any person acting in a representative capacity for another, without regard to whether the debtor's assets are under administration, or whether the debtor is solvent or insolvent, or even whether the federal debt is known to the representative at the time the non-federal debt is paid. In recent years, as we shall see, the Government appears to have been making a determined effort to have the provision applied broadly and literally, without reference to its intimate relationship to the insolvency priority statute. The statute ought to be rewritten in order that none may be in doubt concerning the nature and extent of the obligation imposed.¹⁷⁷

1. *Necessity for Insolvency*

It has been proposed above that the priority rule of Rev. Stat. § 3466 be made applicable to all general administrations for the purpose of paying debts if they terminate in insolvency, even if their initial pur-

174. *King v. United States*, 379 U.S. 329, 336 (1964).

175. In *King v. United States*, 379 U.S. 329 (1964), a receiver was held subject to the personal liability although he acted as an arm of the court rather than as personal representative of the debtor. As heretofore noted (*see* p. 238 *supra*), the Supreme Court in *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 488 (1926), declared that the section 3466 “priority does not attach while the debtor continues the owner and in possession of the property,” a conclusion it fortified (*id.* 490) by reference to the terms of the companion provision (section 3467).

176. *G. P. Fitzgerald*, 4 T.C. 494, 504 (1944).

177. The American Bar Association's Special Committee on Federal Liens did not really address itself to the problems under this statute, but with one exception (*see* note 182 *infra*) undertook only to conform its language to the changes in priorities recommended under section 3466. 84 A.B.A. REP. 733, 735 (1959).

pose is rehabilitation of the debtor and its continuation as a going business.¹⁷⁸ To a considerable extent the law already so applies.¹⁷⁹ In such circumstances, it may be undesirable to tie the fiduciary's hands during the period when the estate is still a solvent operation, even though under administration. Consideration should be given, therefore, to applying the personal liability only to payments made by the fiduciary after insolvency (in the bankruptcy sense) arises, or after a course of liquidation is entered upon.¹⁸⁰

In at least one case, as part of its effort to broaden the reach of the personal liability statute, the Government has apparently gone so far as to argue that officers of a *solvent* corporation, which is not under administration, may be subjected to personal liability whenever they pay any non-federal debt at a time when the corporation is indebted to the Government, should the corporation ultimately be unable to pay—in effect making the officers of almost any corporation guarantors of its federal taxes and other federal debts unless, without regard to due dates, they pay such obligations in advance of any other indebtedness. The imposition of such a liability on the managers of a going concern would be an intolerable burden. While the Government has as yet been unsuccessful in imposing such liability,¹⁸¹ the threat should be removed by clarifying legislation.¹⁸²

2. *Preferences, Where No Administration*

The Government has met with more success in holding liable the officers or managers of a going but *insolvent* corporation who, "under threat of crippling suits,"¹⁸³ make preferential payments to creditors

178. See pp. 249-50 *supra*.

179. Cases cited note 79 *supra*.

180. In a receivership, the general rule is that the fiduciary may be authorized to pay creditors in the normal course, if it appears that assets will be sufficient for all demands; but not after liquidation begins. *Standard Oil Co. v. Grand Rapids Trust Co.*, 98 F.2d 207 (6th Cir. 1938); *Kennebec Box Co. v. O. S. Richards Corp.*, 7 F.2d 290 (2d Cir. 1925).

181. *United States v. Lutz*, 295 F.2d 736 (5th Cir. 1961); cf. *United States v. Sullivan*, 19 F. Supp. 695 (W.D.N.Y. 1937), *aff'd*, 95 F.2d 1021 (2d Cir. 1938).

182. The American Bar Association recommendation would have made clear that only claims against an *insolvent* debtor or estate were covered. 84 A.B.A. REP. 733, 735 (1959).

183. As a matter of fact, in any situations where Rev. Stat. § 3467 applies, not even the fact that payment of the debt is made pursuant to a *levy* by the non-federal creditor would relieve the fiduciary or other person of personal liability to the United States. *Northwestern Jobbers Credit Bureau*, 1 T.C. 863 (1943). A court order likewise affords no protection, *Field v. United States*, 34 U.S. (9 Pet.) 182, 201 (1835); *John H. Beasley*, 42 B.T.A. 275 (1940), unless the United States was properly a party to the proceedings, as in *United States v. Pate*, 47 F. Supp. 965, 968 (W.D. Ark. 1942). However, satisfaction of mortgages or pledges having priority in insolvency is permitted, *Union Guardian Trust Co.*, 41 B.T.A. 1306 (1940), as is the payment of administration expenses and other items the priority of which is recognized. *United States v. Wisconsin Valley Trust Co.*, 233 F.

other than the United States.¹⁸⁴ This is contrary to the traditional function of Section 3467, and also goes beyond the prevailing view under *general* law, which does not frown on preferential transfers by insolvent going businesses unless bankruptcy follows.¹⁸⁵ Nevertheless, it would not seem unreasonable for Congress to penalize those responsible for such transfers, as a means to protect the Government's priority without having to throw the debtor into bankruptcy, pursuing the preferred creditors, and then attempting to prove that they had reasonable cause to believe that the debtor was insolvent.¹⁸⁶ If that is to be the policy, however, corporate managers should be warned more explicitly than they are by the present statute and should be given the right to recover from the preferred creditors.

3. *Distributions to Noncreditors*

Although the statute literally imposes liability only on one who pays "any debt due" to another before he pays the United States, the Government gives a broad construction to the word "debt" and, with some judicial support, would hold liable an executor or administrator who distributes assets to legatees without providing for federal claims.¹⁸⁷ On the other hand, the Tax Court has unanimously declined to impose liability under Section 3467 upon corporate officers who make distributions to stockholders in complete liquidation, holding that such distributions are not payments of "debts" within the meaning of the statute.¹⁸⁸ Whenever assets of either a decedent's estate or a corporation

Supp. 73 (W.D. Wis. 1964); *United States v. Weisburn*, 48 F. Supp. 393 (E.D. Pa. 1943); *Jessie Smith*, 24 B.T.A. 807 (1931), *acquiesced in*, XI-1 CUM. BULL. 6 (1932). Concerning recognized priorities, see notes 69-71 *supra*.

184. *Lakeshore Apartments, Inc. v. United States*, 351 F.2d 349 (9th Cir. 1965) (holding the four month period prescribed in the Bankruptcy Act, 11 U.S.C. § 96(b), to be irrelevant for this purpose); *United States v. Bulls*, 233 F. Supp. 622, 627 (M.D. Ala. 1964), *rev'd on other grounds*, 356 F.2d 619 (5th Cir. 1966); *United States v. Sullivan*, 214 F. Supp. 701 (W.D. Pa. 1963). On the other hand, in *Leon G. Grieb*, 36 T.C. 156 (1961), *acquiesced in*, 1961-2 CUM. BULL. 4, it was held that liability under Rev. Stat. § 3467 attaches only to one who "received the assets from the company . . . for the purpose of liquidating the corporate debts," *id.* at 165, and that "[T]he existence of an *actual* fiduciary relationship is indispensable in placing one within the provision of fiduciary liability. This fiduciary capacity must be established from the very nature of the transaction *rather than through the equitable 'trust fund' doctrine.*" *Id.* at 167 (emphasis added).

185. See 15A W. FLETCHER, PRIVATE CORPORATIONS §§ 7379, 7421-26 (1938).

186. 11 U.S.C. § 96 (1964). A precedent may be found in INT. REV. CODE of 1954, § 6672, imposing personal liability on corporate officers and others who, in breach of trust, pay other debts with funds withheld from wages or otherwise collected as taxes.

187. Treas. Reg. § 25.2502-2. See *Leroy K. New*, 48 T.C. —, No. 65 (1967); *United States v. Munroe*, 65 F. Supp. 213 (W.D. Pa. 1946) (in which the court's reliance on Section 3467 appears to have been unnecessary, since the executrix was also the distributee and was liable in that capacity); *United States v. Rose*, 227 F. Supp. 259 (E.D. Pa. 1964), *aff'd on other grounds*, 346 F.2d 985 (3d Cir. 1965).

188. *Edward G. Leuthesser*, 18 T.C. 1112, 1126-28 (1952), overruling on this point

are paid over or transferred to distributees or stockholders while a federal claim remains unsatisfied, the Government has a clear remedy against those who actually enjoy the benefit. A reasonable argument could be made, therefore, that a further remedy against the distributing officer or fiduciary is unnecessary and improper. On the other hand, Congress may conclude that since it is sometimes impossible or unduly burdensome to recover from the distributees, an alternative remedy should be available against the person who knowingly or negligently created the situation.¹⁸⁹ There is an element of unfairness, however, in imposing personal liability upon the fiduciary as a means of "bailing out" the Government when it has simply *failed to proceed timely* against those who received the benefit.¹⁹⁰ Coordination of the statutes of limitations should, as a minimum, be considered.¹⁹¹ In any event, if it is the intent of Congress that the statute should not mean "debt" when it says "debt," the law should be amended to say what it really means.¹⁹²

4. *Knowledge; Duty of Inquiry*

On its face, the statute makes the fiduciary or other person who pays non-federal claims responsible for debts due to the United States without regard to whether he knew or could reasonably have known that

L. T. McCourt, 15 T.C. 734 (1950). *Accord*, Leon G. Grieb, 36 T.C. 156 (1961). Despite the apparent inconsistency with the position taken, *supra* note 187, the Commissioner acquiesced in *Leuthesser*, 1953-1 CUM. BULL. 5, 1953-2 CUM. BULL. 5, and in *Grieb*, 1961-2 CUM. BULL. 4.

189. The remedy is "alternative," since the fiduciary's liability is limited to the amount of the federal claim which "may be due and unpaid." Rev. Stat. § 3467.

190. The Government's negligence in failing to proceed timely against the distributees is no defense to the fiduciary. *United States v. First Huntington Nat'l Bank*, 34 F. Supp. 578, 584 (S.D. W. Va. 1940), *aff'd* 117 F.2d 376 (4th Cir. 1941).

191. Regardless of state laws barring claims not timely presented in the proceedings (*United States v. Summerlin*, 310 U.S. 414 (1940)), the Government may pursue its remedies against the fiduciary and the distributees within the times prescribed by federal law. 28 U.S.C. § 2415 (Supp. II, 1965-66) (contracts); INT. REV. CODE of 1954, § 6502 (tax claims, generally); *id.* § 6901 (tax claims, where the Government elects the summary means of enforcement there provided). The decisions are in conflict concerning whether, if the Government elects to stay out of the state court proceeding, it may nevertheless pursue the distributees as well as the fiduciary (*United States v. Anderson*, 66 F. Supp. 870 (D. Minn. 1946); *United States v. Fisher*, 57 F. Supp. 410 (E.D. Mich. 1944); see *Vilas v. Commissioner*, 233 F.2d 376, 378, 379 (6th Cir. 1956)) or whether the decree of distribution absolves the distributees and leaves the Government only its remedy against the fiduciary. *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 937 (S.D. Cal. 1966). In any event, the period of limitations under Section 6901 is in some circumstances longer for pursuing the fiduciary than for pursuing those who benefited from his payment. Such was the situation which moved the Commissioner to pursue the corporate officers rather than the distributees in the *Leuthesser* and *Grieb* cases, *supra* note 188.

192. According to A. HERBERT, UNCOMMON LAW, the rule in the English courts is that "If Parliament does not mean what it says it must say so." While perhaps out of fashion in this country as a rule of construction (*Commissioner v. Mercantile Nat'l Bank of Dallas*, 276 F.2d 58, 61 (5th Cir. 1960)), it is not a bad rule for the draftsman.

such debts existed. There are a few decisions that seem to support such an interpretation,¹⁹³ but the prevailing view is that the liability is not to be imposed unless the fiduciary has actual knowledge of the claim, or at least possesses such information "as would put a reasonably prudent man upon inquiry."¹⁹⁴ However, if information does reach the fiduciary from whatever source, formally or informally, timely or untimely, he cannot ignore it.¹⁹⁵ And it is enough that the representative has notice of the Government's intention to assert a liability, even if it has not yet been definitely determined.¹⁹⁶

The extent of the representative's duty of inquiry is uncertain. It has been held that he is not obliged to search for filed notices of federal tax liens, and that such filings impart constructive notice only to purchasers, holders of security interests, and others specified in Section 6323(a) of the Internal Revenue Code, but not to a fiduciary administering the taxpayer's estate.¹⁹⁷ Further, it has been held that the fiduciary has no affirmative duty to inquire of the tax collector and other possible federal creditors of the decedent or other insolvent concerning the existence of priority obligations unknown to him;¹⁹⁸ and even the

193. See *Elva S. Evans*, 12 B.T.A. 334 (1928). In *Giovaninni Terranova*, 2 CCH Tax Ct. Mem. 616 (1943), the Commissioner of Internal Revenue admitted that the administrators had no knowledge of the tax liability, but contended—unsuccessfully on that occasion—that the Section 3467 liability was absolute.

194. *Want v. Commissioner*, 280 F.2d 777, 782-83 (2d Cir. 1960); *Irving Trust Co.*, 36 B.T.A. 146 (1937), *acquiesced in* 1937-2 CUM. BULL. 15; *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 937 (S.D. Cal. 1966); *Livingston v. Becker*, 40 F.2d 673, 675 (E.D. Mo. 1929); *United States v. Clark*, 25 F. Cas. 447, 450 (No. 14,807) (C.C.N.Y. 1826) "It is enough if the trustees be in possession of such facts as that a faithful and fair discharge of his duty would put him on inquiry". Although Treas. Reg. § 25.2502-2 (1967) states an executor's or administrator's liability for a decedent's gift taxes in absolute terms, Treas. Reg. § 1.641(b)-2(a) (1967), relating to a decedent's income taxes, refers to the case where the fiduciary "had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed," while the "prudent man" test quoted in the text is applied in the same circumstance in Rev. Rul. 66-43, 1966-1 CUM. BULL. 291. In Treas. Reg. § 301.6371(a)-2(c) (1967), dealing with bankruptcy trustees, receivers, and the like, the responsibility is stated narrowly, referring to "taxes of which he has notice." In any event, lack of knowledge is defensive, and must be proved by the fiduciary. *L. T. McCourt*, 15 T.C. 734 (1965). See generally Annot., 41 A.L.R.2d 446, 450 (1955).

195. *United States v. Kaplan*, 74 F.2d 664 (2d Cir. 1935); *Leroy K. New*, 15 T.C. —, No. 65 (1967); *United States v. Luce*, 78 F. Supp. 241 (D. Minn. 1948). Where the fiduciary is a trustee in *bankruptcy*, however, as in the *Kaplan* case, he has been protected since 1938 by the absence of a timely-filed proof of the Government's claim. 11 U.S.C. § 93(n) (1964). As the *Luce* case demonstrates, an executor, assignee for creditors, or receiver would enjoy no such protection, if he learns of a federal claim not timely and formally filed with him. Cf. *United States v. Summerlin*, 310 U.S. 414 (1940).

196. *Want v. Commissioner*, 280 F.2d 777, 783 (2d Cir. 1960); *United States v. Purdome*, 240 F. Supp. 221, 223 (W.D. Mo. 1963); *United States v. Luce*, 78 F. Supp. 241 (D. Minn. 1948). The threat of a contingent claim of the Government, which might result in personal liability on the fiduciary, is sufficient justification for his delaying the payment of other debts. *Pennsylvania Cement Co. v. Bradley Contracting Co.*, 274 F. 1003 (S.D.N.Y. 1920).

197. *Livingston v. Becker*, 40 F.2d 673 (E.D. Mo. 1929).

198. *Irving Trust Co.*, 36 B.T.A. 146, 149 (1937). See *Delaware v. Irving Trust Co.*

failure of the fiduciary to advise such authorities of the administration of the estate has been held not to render him personally liable under Section 3467.¹⁹⁹ The latter decisions, however, did not involve the effect of a provision enacted in 1954 requiring "[e]very receiver, trustee in bankruptcy, assignee for benefit of creditors, or other like fiduciary, and every executor" or administrator to give notice of his qualification to the appropriate District Director of Internal Revenue.²⁰⁰ While that statute makes no reference to Section 3467, it might well be construed to alter the duty of inquiry concerning federal taxes to which a "reasonably prudent man" would be subject, although this is far from certain.²⁰¹ Since the unpaid federal taxes are a distinct possibility for every insolvent estate under administration, it does not seem unduly burdensome *expressly* to condition the fiduciary's relief from liability upon his compliance with his statutory duty to notify the District Director of his appointment, in order that claims otherwise unknown to the fiduciary may be asserted. While that may be the effect of present law,²⁰² fiduciaries should be left in no doubt on the matter.

A 168-year-old penal statute that, on its face, imposes a duty in absolute terms, without regard to "guilty knowledge," ought no longer to be tolerated.²⁰³ Congress should spell out, as precisely as possible, the

92 F.2d 17 (2d Cir. 1937). *But cf.* Treas. Reg. § 1.641(b)-2 (1967), *supra* note 194. Once the fiduciary knows facts which put him on inquiry that a claim may exist, however, an inquiry that stops short of the appropriate government agency may be insufficient (Leroy K. New, 48 T.C. —, No. 65 (1967)), although it has been held that he need not "remind the Government of all of the potential claims that it might have . . . and suggest that they be prosecuted." *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 936 (S.D. Cal. 1966).

199. *Want v. Commissioner*, 280 F.2d 777, 781-82 (2d Cir. 1960); *Irving Trust Co.*, 36 B.T.A. 146, 149 (1937).

200. INT. REV. CODE of 1954, § 6036; Treas. Reg. § 301.6036-1 (1967). Of the authorities last cited (note 199 *supra*), *Irving Trust* antedated the enactment of the provision and *Want* involved a kind of fiduciary outside its scope. In bankruptcy, notice to the Government is required to be given by the court pursuant to 11 U.S.C. § 94(e) (1964).

201. Section 6036 itself imposes only the duty, but provides no sanction. A moderate civil penalty, applicable only to executors, is imposed by INT. REV. CODE of 1954, § 7269; and the general criminal sanctions for willful failure to supply information (*id.* § 7203) may be applicable. Treas. Reg. § 301.6036-1(f)(1) (1967). But no other civil sanction is mentioned. An older provision dealing with giving the tax collector notice of a fiduciary relationship (now INT. REV. CODE of 1954, § 6903) was held, in the cases cited *supra* note 199, to have a different purpose, and failure to give notice thereunder did not result in personal liability under Rev. Stat. § 3467 for disregarding federal obligations unknown to the fiduciary. Unlike Section 6903, however, Section 6036 is framed in terms of a positive duty. Nevertheless, at least in the case of decedents' estates, a purpose of section 6036 to aid in the collection of an insolvent's taxes seems to be negated by Treas. Reg. § 20.6036-1 (1967), which relieves the executor of the obligation of notification if the gross assets are less than \$60,000.

202. Note 201 *supra*.

203. One is reminded of Gilbert & Sullivan's Mikado who said, "That's the pathetic part of it. Unfortunately, the fool of an Act says 'compassing the death of the Heir Apparent.' There's not a word about mistake . . . Or not knowing . . . Or having no notion . . . Or not being there . . . There should be, of course . . . But there

circumstances which will give rise to liability.²⁰⁴ The fact that the Internal Revenue Service seems now to have adopted the "prudent man" test gives no assurance that some other federal agency, or even the Service itself, may not again attempt to apply the statute literally.²⁰⁵

C. Priority and Dischargeability of Federal Taxes in Bankruptcy

1. "Stale" Tax Claims

The fundamental policies of the Bankruptcy Act are to provide a means for (1) the effective rehabilitation of the bankrupt, and (2) the equitable distribution of his assets among his creditors.²⁰⁶ Accordingly, unless he has been guilty of misconduct that is deemed to make him unworthy of relief, the debtor may be discharged of his general debts.²⁰⁷ His creditors divide his assets pursuant to the theoretical ideal of equality,²⁰⁸ subject to exceptions dictated by practicality (administration expenses) or humanity (wages).²⁰⁹ Those policies, of course, come into head-on collision with traditional notions of sovereign prerogative.²¹⁰ For generations it was not thought fitting that one should be able to rid himself of his tax liabilities by going through bankruptcy, so taxes were made nondischargeable.²¹¹ And governmental claims,

isn't That's the slovenly way in which these Acts are always drawn. However, cheer up, it'll be all right. I'll have it altered next session. Now let's see about your execution"

204. The Special Committee of the American Bar Association, being unable to agree, backed away from an attempt to define the "prudent man" standard by law, but declared that "[i]t is not intended to change the present rule under which the fiduciary is relieved of liability if he had no reason to know of the claim of the United States." 84 A.B.A. REP. 735 (1959). A later proposal by the Committee on Estate and Gift Taxes of the Section of Taxation, which would have confined the obligation to cases in which the payor "knows, or reasonably should know" of the federal claim, was laid aside in order to avoid interference with the progress of the primary recommendations. A.B.A. SECTION ON TAXATION, 1960 PROGRAM & COMMITTEE REPORTS 35-37. The definition of "actual notice or knowledge" added by Section 101(a) of the Federal Tax Lien Act of 1966 to INT. REV. CODE OF 1954, § 6323(i)(1), using the Commercial Code test of "due diligence," may be an appropriate formulation, with the addition suggested in the next paragraph of the text.

205. Compare Rev. Rul. 66-43, 1966-1 CUM. BULL. 291, *supra* note 194, with *United States v. Vibradamp Corp.*, 257 F. Supp. 931, 935 (S.D. Cal. 1966), in which the Government argued that the fiduciary "acts at his peril if he distributes the estate without first making certain that no branch of the Federal Government is holding a claim against the estate that it might assert in the near or remote future."

206. H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965); S. REP. NO. 1158, 89th Cong., 2d Sess. 2 (1966).

207. 11 U.S.C. §§ 32, 35(a) (1964).

208. *Sampson v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941).

209. 11 U.S.C. § 104 (1964).

210. With respect to the pre-1966 resolution of the policy conflict, the Supreme Court stated that "it demonstrates congressional judgment that certain problems—e.g., those of financing government—override the value of giving the debtor a wholly fresh start." *Bruning v. United States*, 376 U.S. 358, 361 (1964).

211. Bankruptcy Act of 1898 § 17(a)(1), ch. 541, § 17(a)(1), 30 Stat. 550, as amended, 11 U.S.C. § 35(a)(1) (Supp. II, 1965-66).

although progressively less favored as against certain claims than in non-bankruptcy insolvency proceedings, were nevertheless required to be satisfied before *general* unsecured creditors.²¹² As tax burdens became ever greater, however, the policy conflict became more acute. Individuals discharged in bankruptcy found themselves with their largest liabilities still hanging over them (although corporate taxpayers, simply because they ceased to exist, were relieved of their unsatisfied obligations).²¹³ General creditors frequently found that the crumbs left for them after satisfaction of priority claims were a meager diet indeed. The problems were compounded when taxes were allowed to accumulate over an extended period,²¹⁴ as might occur when the liabilities were in controversy. In the absence of voluntary disclosure by the debtor,²¹⁵ creditors had no means of ascertaining the extent of their possible exposure unless and until public notice of the liability was filed, an act which was not prerequisite to the priority of the tax over general unsecured creditors²¹⁶ and which would occur, if at all, only after final determination of the liabilities.

For more than a decade, therefore, the National Bankruptcy Conference led a campaign to minimize the adverse effects of accumulated taxes in bankruptcy by confining the favored status of taxes to those most recently incurred. The Treasury adamantly opposed the proposal. The issue was not one that could be resolved in terms of right and wrong. In bankruptcy, necessarily, some "innocent" parties must suffer, because of the hard economic facts of business or personal failure. The ultimate issue, as it was succinctly expressed by the Judiciary Committees of Congress, is "whether the Government as a creditor should bear part of the economic burden of business failures through the loss of some of its tax claims which it has allowed to accumulate over a long period of years."²¹⁷

212. 11 U.S.C. § 104(a)(4)-(5) (1964). See Part II.A.

213. H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965); S. REP. NO. 1158, 89th Cong., 2d Sess. 2 (1966).

214. *E.g., In re Weissman*, 178 F. 115 (D. Conn. 1910).

215. The debtor might himself be unaware of the extent of his undertermined tax liabilities. And, even if he knew, he might conceal or misrepresent the facts. The fact that he might thereby risk his right to a discharge (11 U.S.C. § 32(c) (1964)) would be small comfort to the creditors who might lose all the bankrupt's existing assets to the Government's undisclosed prior claim. H.R. REP. NO. 687, 89th Cong., 1st Sess. 4 (1965); S. REP. 1158, 89th Cong., 2d Sess. 4 (1966).

216. Even though it was finally settled in *United States v. Spcers*, 382 U.S. 266 (1965), that unfiled federal tax liens did not enjoy *lien* priority in bankruptcy, only *priority* creditors benefited thereby, since unsecured taxes still prevailed over general creditors. 11 U.S.C. § 104(a)(4) (1964).

217. H.R. REP. NO. 687, 89th Cong., 1st Sess. 4 (1965); S. REP. NO. 1158, 89th Cong., 2d Sess. 4 (1966).

At the outset, bills were introduced which provided that taxes which "became legally due and owing" more than *one year* before bankruptcy should be dischargeable like other debts, and should also not enjoy the priority normally accorded tax claims as against general creditors. That was a plainly impracticable proposal, however, since it failed to take account of the time required to determine a controverted tax liability. By a process of concession and accommodation, which never succeeded in mollifying Treasury opposition but which sufficed to win Congressional enactment in 1966,²¹⁸ a bill evolved which was better than either the pre-existing situation or the original proposal, but which is nevertheless a mishmash of ambiguities and inconsistencies, satisfying no one. Now that Congress has settled the policy conflict that kept the contending forces at arms' length and precluded a mutual effort to perfect the proposal while it was pending, it may be hoped that revisions can be made, within the confines of the established policy, to make the new law understandable and workable.

As enacted, the law provides for the discharge and for the loss of priority status of taxes which "became legally due and owing" more than *three years* before bankruptcy—a period which corresponds to the basic period of limitations for the *determination* of federal taxes,²¹⁹ and which the supporters of the bill thought would afford ample opportunity not only to assess any tax but also to collect it or to protect the claim by filing notice of a lien.²²⁰ In partial recognition of the practicalities, however, exceptions were provided for cases (1) where the bankrupt had failed to make a return required by law, if the tax was not assessed or was assessed within one year before bankruptcy; (2) where the tax liability was not reported on the return made by the bankrupt and was not assessed before bankruptcy "by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt"; (3) where the bankrupt had "made a false or fraudulent return, or willfully attempted in any manner to evade or defeat" the tax; and (4) where the amount was collected

218. Pub. L. 89-496, §§ 2.3, 80 Stat. 271 (1966), amending 11 U.S.C. §§ 35(a)(1) and 104(a)(4). This legislation was separate from the Federal Tax Lien Act of 1966, heretofore discussed. The background of Public Law 89-496 is set out in Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L. REV. 149, 171-72 (1967).

219. INT. REV. CODE of 1954, § 6501(a). The period is longer, however, in case of certain substantial omissions from a return (§ 6501(e)), and is unlimited in cases of fraud or failure to file a return (§ 6501(c)). The time also may be extended by agreement (§ 6501(c)(4)), and is suspended upon the issuance of a deficiency notice, and until a decision of the Tax Court if a petition thereto is filed (§ 6503(a)(1)).

220. H.R. REP. No. 687, 89th Cong., 1st Sess. 2 (1965); S. REP. No. 1158, 89th Cong., 2d Sess. 2-3 (1966).

or withheld by the bankrupt from others and was not paid over. It was further provided that a discharge should not bar any remedies available against the debtor's property exempt from bankruptcy,²²¹ and should not "release or affect any tax lien."²²²

The fundamental uncertainty in the new statute is when the three-year period starts to run—i.e., when a tax becomes "legally due and owing."²²³ The only assistance afforded by the legislative history lies in a unilateral statement made during floor debate by the Senate sponsor of the bill, Senator Ervin,²²⁴ to the effect that individual income taxes "are legally due and owing on the 15th of April."²²⁵ Presumably, under that view, other taxes would also become "legally due and owing" on the date set for their payment, whether or not they had been assessed.

But at least two other interpretations are possible. The Treasury suggested at the hearings,²²⁶ and the Senate Finance Committee reiterated in its report supporting the Treasury position,²²⁷ that the act might be construed to refer to the assessment date as the starting point, an interpretation that would deny relief in the case of all unassessed taxes, no matter how many years might have passed without administrative action.²²⁸ That interpretation is unlikely to prevail, since it would render meaningless certain of the express exceptions provided in the law; but litigation may be necessary to set the matter at rest.

I submit, however, that still a third interpretation is possible, and may start the time running sooner than anyone anticipated or intended.

221. See *United States v. Heffron*, 158 F.2d 657 (9th Cir. 1947), *cert. denied*, 331 U.S. 831 (1947). Concerning exemptions generally, see Part IV.A.1, in the second installment of this article.

222. Note 218 *supra*.

223. See W. PLUMB & L. WRIGHT, *supra* note 3, at 172-74, from which the following discussion is, in part, drawn.

224. Concerning the limited weight of interpretative statements in debate, see *Federal Trade Comm. v. Raladam Co.*, 283 U.S. 643, 650-51 (1931); *United States v. St. Paul M. & M. Ry.*, 247 U.S. 310, 318 (1918); *United States v. Sears, Roebuck & Co.*, 111 F. Supp. 614, 618-19 (S.D.N.Y. 1953).

225. 112 CONG. REC. 13177 (daily ed. June 21, 1966).

226. *Hearings on S. 976 (H.R. 3438) and S. 1912 (H.R. 136) before the Senate Committee on Finance*, 89th Cong., 1st Sess. 9 (1966).

227. S. REP. NO. 999, 89th Cong., 2d Sess. 2-3, 7, 8 (1966). See also 112 CONG. REC. 13175 (daily ed. June 21, 1966) (remarks of Senator Gore).

228. The Treasury might point to the fact that, whereas payment of original tax is required to be made on the due date of the return, unless extension is granted (INT. REV. CODE of 1954, § 6151(a)), payment of deficiencies becomes due only after notice and demand (which follows assessment) (*id.* § 6155(a)); but the fact that interest runs from the original due date (*id.* § 6601(a)) points the other way. Significantly, the Finance Committee substitute, which would have measured the time from the assessment date (S. REP. NO. 999, 89th Cong., 2d Sess. 22 (1966)), was not even put to a vote in the Senate, after another portion of the substitute proposal (relating to discharge, see note 248 *infra*) was defeated. 112 CONG. REC. 13178-13186 (daily ed. June 21, 1966).

Contrary to statements by opponents of the bill that the phrase "legally due and owing" had no established meaning,²²⁹ it has been in the priority section since 1898, and has often been construed by the courts. The Supreme Court held as long as 60 years ago that a tax was "legally due and owing" when the event occurred that fixed the liability for tax, even though a return was not due and the tax was not collectible until a later date.²³⁰ On that theory, income taxes would become "legally due and owing" neither on April 15 nor on the later assessment date, but on the last day of the taxable year;²³¹ and employment and other excise taxes, being apportionable, would become "legally due and owing" as each wage payment or taxable transaction occurs, without even awaiting the end of the period for which a return is required to be made.²³² Such an interpretation would not effectuate the apparent intention to allow the Treasury at least the minimum three-year period provided for determining the tax liability (which never starts to run before the due date of the return),²³³ yet it seems to follow from the unfortunate adoption of a phrase having an established meaning for another purpose.

One remedy might be for Congress now to define "legally due and owing" by reference to the time when the tax would become payable if the full liability had been properly reported or determined at the outset (assuming, as appears to be the case, that the assessment date is not to be decisive, except in the special situations expressly dealt with). It would be better, however, to use and define entirely different terminology, for a redefinition of "legally due and owing" could have undesirable collateral consequences in throwing into the priority category of "administration expenses," or perhaps into limbo, certain taxes aris-

229. S. REP. NO. 999, 89th Cong., 2d Sess. 7 (1966).

230. *New Jersey v. Anderson*, 203 U.S. 483, 494 (1906). See also *New York v. Jersawit*, 263 U.S. 493 (1924); *Massachusetts v. Meeham*, 67 F.2d 638 (1st Cir. 1933), *cert. denied*, 291 U.S. 666 (1934).

231. Income taxes are not apportionable, since events late in the year may wipe out the tax on earlier income. *In re Sussman*, 289 F.2d 76, 77 (3d Cir. 1961), *overruled on other grounds*, *Segal v. Rochelle*, 382 U.S. 375 (1966); cf. *In re International Match Corp.*, 79 F.2d 203 (2d Cir. 1935), *cert. denied*, 296 U.S. 652 (1935). Thus, if a bankruptcy petition is filed on February 15, 1967, and no exception is applicable, this view would discharge and would deny the priority of income taxes for calendar years through 1963, while Senator Ervin's view would exclude the tax for 1963 (the due date of which fell within the three year period).

232. *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955); *Pomper v. United States*, 196 F.2d 211 (2d Cir. 1952); cf. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 103 (3d Cir. 1964). Thus, if bankruptcy occurs on February 15, 1967, this view would discharge and deny priority for taxes on transactions occurring before February 15, 1964, regardless of the due dates of the taxes.

233. INT. REV. CODE OF 1954, § 6501(a), (b).

ing entirely from activities antedating bankruptcy but not falling due until after.²³⁴

Among the statutory exceptions, the most important is the one for cases where the liability was subject to "a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt."²³⁵ The "prohibition"—and hence the exception—would be applicable to deficiencies in income taxes (and, probably rarely, estate and gift taxes), left over from the bankrupt's more prosperous days, whether the controversy at the time of bankruptcy had reached the Tax Court, or was actively subject to administrative negotiations, or was simply held in an inactive file under extensions of the statute of limitations.²³⁶

Actually, the "prohibition" is by no means absolute, since immediate assessment is permitted if the collection of the tax is found to be in jeopardy—as it surely would be if bankruptcy impends.²³⁷ The most that can be said is that when the collection officer has no assessment on his books, he may not be alerted to keep an eye on the taxpayer's financial condition during the administrative or judicial consideration of the challenged tax liability. But that is equally true of employment or other excise taxes which are being contested in good faith in the tax collector's office when bankruptcy occurs. Such taxes are not subject to even a nominal "prohibition" on assessment, and only administrative self-restraint prevents assessing and collecting at any time the maximum amount claimed by the Government, leaving the taxpayer to his remedy by suit for refund.²³⁸ Hence, assuming no other exception is applicable,²³⁹ Congress has elected to assume the risk in such cases that the older liabilities, though still undetermined, will lose their priority and

234. See *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964). See notes 283-94 *infra*.

235. 11 U.S.C. § 35(a)(1)(c) (Supp. II, 1965-66), which, like the other exceptions, heretofore mentioned, is incorporated by reference in 11 U.S.C. § 104 (a)(4) (Supp. II, 1965-66).

236. INT. REV. CODE of 1954, § 6213(a).

237. INT. REV. CODE of 1954, § 6861(a). See also *United States v. Clover Spinning Mills Co.*, 373 F.2d 274, 278 (4th Cir. 1966). The only absolute barrier to prompt assessment arises when the Tax Court has determined a deficiency less than was claimed; the Commissioner, pending an appeal to higher courts, cannot make a jeopardy assessment greater than the Tax Court found. INT. REV. CODE of 1954, § 6861(d). In all other cases, a question might be raised whether the failure to assess before bankruptcy actually occurred "by reason of" a prohibition that is so readily overcome. *But cf. Mutual Lumber Co. v. Poe*, 66 F.2d 904, 907, 908 (9th Cir. 1933), *cert. denied*, 290 U.S. 706 (1934). See Part V.A, in the third installment of this article.

238. *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1 (1962).

239. As noted above, amounts which the bankrupt has collected or withheld from others and has not paid over are excepted, so only the liabilities imposed on the bankrupt himself are referred to here. The fraud and no-return exceptions could also be applicable. 11 U.S.C. § 35(a)(1)(a), (d) (Supp. II, 1965-66).

be discharged if bankruptcy intervenes.²⁴⁰ Yet the tax collector's hands, as a practical matter, are no more tied in the one case than in the other.

It is probably unnecessary, however, and almost certainly futile, to attempt to rationalize an inconsistency in a provision that evolved through compromise of irreconcilable positions. Perhaps the justification may be found not in the ephemeral "prohibition" on which the statute relies, but in the fact that income taxes involve greater complexities than others, and hence may require more time for audit, so that some yielding of the bankruptcy policy against excessive accumulations is necessary.²⁴¹

If the exception for such situations is justifiable, however, it should be made workable. As the Finance Committee vainly pointed out, the bill as enacted left "problems when the exception terminates—for example, when the administrative or judicial remedies have been exhausted."²⁴² The moment the restrictions on assessment are removed (by the taxpayer's execution of a waiver thereof, by his failure to file a petition to the Tax Court with respect to a deficiency notice, or by a Tax Court decision), the exception is no longer applicable. If bankruptcy occurs before that moment, the tax is protected from discharge and loss of priority, no matter how old the liability may be. But if bankruptcy occurs a moment later, and the liability is over three years old, discharge and loss of priority will occur (unless some other exception is applicable).²⁴³ Under normal procedures, up to 30 days may elapse before assessment is made, and as much as six months more before the failure of letters to elicit voluntary payment leads the tax collector to investigate the delinquent's financial condition and to consider the necessity for filing notice of lien.²⁴⁴ It was apparently in recognition of that practical collection problem that another exception, applicable where the taxpayer had *failed to file a return*, postponed the effect of the provisions for discharge and loss of priority, not only until an assessment was made but also for one year thereafter.²⁴⁵ A similar

240. It is here assumed that the interpretation contained in notes 226-28 *supra*, that the three year period runs from the *assessment* date, is not adopted.

241. H.R. REP. NO. 687, 89th Cong., 1st Sess. 2 (1965); S. REP. NO. 1158, 89th Cong., 2d Sess. 2 (1966).

242. S. REP. NO. 999, 89th Cong., 2d Sess. 8 (1966).

243. The Treasury expressed the fear that a taxpayer might take advantage of the interval between removal of the restrictions and the assessment and filing of the lien to file a voluntary petition in bankruptcy. H.R. REP. NO. 687, 89th Cong., 1st Sess. 6 (1965).

244. The procedure is outlined in S. REP. NO. 999, 89th Cong., 2d Sess. 4-5 (1966). Until notice of the lien is filed, the Government's position remains vulnerable. P. 241 & note 105 *supra*.

245. 11 U.S.C. §§ 35(a)(1)(a), (b), 104(a)(4) (Supp. II, 1965-66).

extension of the "prohibition" exception, allowing one year after assessment (or perhaps one year after the restriction is removed) to collect the tax by normal procedures or to determine that more drastic action is necessary, would help to forestall precipitate action in filing liens that might cut off the taxpayer's credit and force a shaky but not hopeless business into bankruptcy.²⁴⁶

A number of flaws in the new law result from unwisely tying together by cross-reference the conditions under which a discharge is permitted and those under which priority will be denied.²⁴⁷ The relevant policy considerations are not the same.²⁴⁸ Thus, in the situation last discussed, it may well be that—even though an accumulation of liabilities results—a taxpayer should not reap a benefit, through *discharge*, from a delay in assessment that occurred for his own accommodation while he unsuccessfully contested the tax (and this without regard to whether assessment was nominally "prohibited"). Yet the bankruptcy policy against excessive accumulation of claims enjoying *priority* over general creditors,²⁴⁹ if it could be considered in isolation from the problem of discharge, might well dictate denying such priority to the older taxes (again irrespective of whether the delay reflected a nominal "prohibition" or only administrative self-restraint).

The error in linking the discharge and priority rules is most evident in situations where the taxpayer has failed to file required returns, or has filed false and fraudulent returns or otherwise willfully attempted to evade and defeat the tax.²⁵⁰ In such cases there is no statute of limitations on assessment of the tax,²⁵¹ so the Government can, and often does, reach back many years to determine taxes and penalties. It may well be consistent with bankruptcy policy,²⁵² despite the impediment to rehabilitation, to deny the bankrupt a discharge from such accumulated

246. See S. REP. NO. 999, 89th Cong., 2d Sess. 5 (1966); *Hearings on S.976 and S.1912 before the Senate Committee on Finance*, *supra* note 226, at 8, 15.

247. 11 U.S.C. § 104(a)(4) (Supp. II, 1965-66).

248. See Kennedy, *supra* note 218, at 180. It may be noted that the Treasury and the Senate Finance Committee, while giving a qualified approval to the principle that, after a certain time, taxes should be *denied priority* over general creditors, opposed the *discharge* of older taxes, proposing instead to limit the portion of an individual's subsequent earnings which he would be required to devote to payment of pre-bankruptcy taxes, if he had not been guilty of specified misconduct or omissions. S. REP. NO. 999, 89th Cong., 2d Sess. 8-10, 14-16 (1966). The proposal was defeated in the Senate. See note 228 *supra*.

249. Note 217 *supra*.

250. 11 U.S.C. § 35(a)(1)(a), (b), (d) (Supp. II, 1965-66).

251. INT. REV. CODE OF 1954, § 6501(c)(1), (2), (3).

252. Cf. 11 U.S.C. § 32(c) (Supp. II, 1965-66). See also *World Scope Publishers, Inc. v. United States*, 348 F.2d 640 (2d Cir. 1965).

liabilities because of his misconduct or default²⁵³ (although, in the case of an innocent failure to file a return, the penalty may be unduly harsh).²⁵⁴ But what is the warrant for visiting the "penalty" upon his creditors? In general, the policy of the Bankruptcy Act is to relieve the bankrupt estate of penalties imposed for the bankrupt's misconduct or omissions.²⁵⁵ It would be more consistent with that policy not to allow priority, at the expense of innocent creditors, for an accumulation of taxes that could not be collected were it not for such misconduct or omissions (and hence are in the nature of a penalty). Perhaps some reasonable enlargement of the three-year period is warranted by the greater difficulty of discovering the liability in such cases, but the accumulation of claims having priority should not be unlimited.²⁵⁶

A major ambiguity in the discharge section is found in the proviso that "a discharge in bankruptcy shall not release or affect any tax lien."²⁵⁷ That proviso, inserted to mollify the Government, was nevertheless criticized by it as either completely meaningless or so broad in its effect as to nullify the discharge.²⁵⁸ On the one hand, it was suggested that the courts might hold that the lien, although not "release[d] or affect[ed]," could not be enforced because there was no longer a personal liability to support it or to which the proceeds could be applied. Liens existing where there is no personal liability are commonplace, however, real property taxes and certain mortgages being instances that come to mind. If Congress says the lien exists though the debt is discharged, no court is going to say that is a legal impossibility.

The problem really is not whether the lien continues to exist and can be enforced, but what it attaches to. An extreme interpretation was

253. H.R. REP. NO. 687, 89th Cong., 1st Sess. 3 (1965); S. REP. NO. 1158, 89th Cong., 2d Sess. 3 (1966).

254. Unlike the provision imposing a penalty for failure to file a return (INT. REV. CODE OF 1954, § 6651(a)), the denial of a discharge applies irrespective of whether there is "reasonable cause" rather than "willful neglect." And, even for penalty purposes, an inadvertently unsigned or otherwise incomplete return is considered no return. *Plunkett v. Comm'r*, 118 F.2d 644, 650 (1st Cir. 1941). Yet, if bankruptcy happens to be delayed until a year after the default is discovered and an assessment is made, even the most inexcusable failure (if not fraudulent) is not penalized by denial of a discharge. 11 U.S.C. § 35(a)(1)(a) and (b) (Supp. II, 1965-66).

255. 11 U.S.C. § 93(j) (1964). See *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962).

256. The law now penalizes creditors by granting priority for an accumulation of fraudulent tax deficiencies, even if the fraud had been discovered and the tax assessed long before bankruptcy. 11 U.S.C. § 35(a)(1)(d). (Supp. II, 1965-66), made applicable by § 104(a)(4) (Supp. II, 1965-66).

257. 11 U.S.C. § 35(a)(1) (Supp. II, 1965-66).

258. H.R. REP. NO. 687, 89th Cong., 1st Sess. 6-7 (1965) (Treasury Dep't views); S. REP. NO. 114, 89th Cong., 1st Sess. 13-14 (1965) (Justice Dep't views, set out in the report on a companion bill, but not reprinted in the reports on the identical bill finally enacted).

suggested, but not necessarily advocated, by the Justice Department,²⁵⁹ to the effect that if a three-year-old tax had been *assessed* before bankruptcy (and thus had become a lien, whether or not notice was filed),²⁶⁰ the lien would remain effective not only against property owned by the debtor at the time of bankruptcy but also against his future earnings and any property he later acquires, until the statute of limitations bars the tax—a view which would wholly nullify the discharge of personal liability in the case of every assessed tax, even though the terms of the exceptions show an intent to discharge some assessed taxes.²⁶¹

A third interpretation, which does no violence to the purpose of the statute, would preserve the lien, but only on property owned by the taxpayer at the time of bankruptcy.²⁶² Although the federal tax lien does attach to after-acquired property,²⁶³ it attaches only when such property is acquired;²⁶⁴ and the discharge of the personal liability should prevent the *floating* lien from reaching new property, even though the lien is preserved against property to which it had already attached. So construed, the proviso would be declaratory of the established bankruptcy principle that mortgages and liens remain enforceable against the security even though the debt has been discharged,²⁶⁵ but that security interests attaching to the future earning power of the bankrupt do not survive.²⁶⁶ The language would serve a useful purpose in preserving the lien for purposes of distributing the proceeds of

259. S. REP. NO. 114, 89th Cong., 1st Sess. 13-14 (1965).

260. The lien is valid against the taxpayer, although not against the trustee, *United States v. Speers*, 382 U.S. 266 (1965), without need for filing. INT. REV. CODE OF 1954, §§ 6321, 6322, 6323(a).

261. As already noted, an *unassessed* income tax is dischargeable only if bankruptcy occurs in the interval of perhaps 30 days between removal of the prohibition and actual assessment. If *assessed* taxes are not subject to discharge, the discharge provision would be virtually inoperative except with respect to unassessed excise and employment taxes (other than "trust fund" liabilities).

262. "As with other secured claims like mortgages and conditional sales contracts, the purpose of the lien is to give the creditor a property interest which is indefeasible in bankruptcy. Thus, to the extent that the tax authorities may satisfy their claims *out of the security they hold*, they will be unaffected by the discharge regardless of the fact that the underlying debt may include taxes for years prior to the 3-year period preceding bankruptcy. The second proviso to section 17a(1) [11 U.S.C. § 35(a)(1) (Supp. II, 1965-66)] proposed by section 2 of this bill emphasizes this legislative intent. There is no intention to alter the relative position in the *distribution of the bankrupt's assets*, which is now given to a tax lien on personalty unaccompanied by possession by the postponement provision of section 67c." H.R. REP. NO. 687, 89th Cong., 1st Sess. 3 (1965) (emphasis added).

263. *Glass City Bank v. United States*, 326 U.S. 265 (1945).

264. *In re Halprin*, 280 F.2d 407 (3d Cir. 1960); cf. *United States v. Long Island Drug Co.*, 115 F.2d 983, 986 (2d Cir. 1940).

265. *Prebyl v. Prudential Ins. Co.*, 98 F.2d 199, 200 (8th Cir. 1938), *cert. denied*, 305 U.S. 341 (1938). See Kennedy, *supra* note 218, at 178.

266. *Local Loan Co. v. Hunt*, 292 U.S. 234, 242 (1934). See Kennedy, *supra* note 218, at 178-179.

liened property coming into the hands of the trustee (if the lien has been filed and is thus valid against the trustee);²⁶⁷ and it would also preserve the lien (whether filed or not) against the bankrupt's exempt property, thereby fortifying the provision preserving the Government's right to enforce the otherwise discharged tax against such property.²⁶⁸

One objection the Treasury raised to the bankruptcy amendments was that they would make the tax collector reluctant to enter into deferred payment arrangements with hard-pressed taxpayers who might appear able to work out of their difficulties if given time. Under its power to compromise tax liabilities,²⁶⁹ the Government may refrain from filing notice of its lien, or may release a lien already filed, in order that a taxpayer who is conscientiously meeting his payments under such an arrangement may deal freely with his property, unhampered by a filed lien against all his assets. When the payment period extends beyond the three-year limitation, however, the Government now risks the loss of the superior position which its lien, if filed, would have enjoyed in bankruptcy, and also risks the discharge of the liability for the deferred payments. Thus, the tax collector might seize the taxpayer's home or other assets rather than enter into such an arrangement.²⁷⁰

The Treasury proposed, therefore, that provision be made for filing notice of such a compromise arrangement, in the same manner as a notice of lien, but without the effect of a filed lien except as against the trustee in bankruptcy. The proposal won the approval of the Finance Committee,²⁷¹ and was apparently acceptable in principle to at least one representative of the National Bankruptcy Conference,²⁷² but it fell with the rest of the Treasury substitute.²⁷³ It should now be given further consideration. By itself, however, it merely protects the priority of the tax claim and may not prevent the discharge of the bankrupt's liability (unless, as discussed above, the "lien" survives against his *future* earnings and assets).²⁷⁴ Perhaps the obligation to comply with such a deferred payment arrangement should be made nondischargeable, subject to such limitations as may be thought appropriate.²⁷⁵

267. *United States v. Speers*, 382 U.S. 266 (1965).

268. 11 U.S.C. § 35(a)(1) (Supp. II, 1965-66).

269. INT. REV. CODE OF 1954, § 7122.

270. H.R. REP. NO. 687, 89th Cong., 1st Sess. 6 (1965) (Treasury Dep't statement).

271. S. REP. NO. 999, 89th Cong., 2d Sess. 6, 13 (1966).

272. *Hearings on S.976 (H.R. 3438) and S.1912 (H.R. 136) Before the Senate Comm. on Finance*, 89th Cong., 1st Sess. 9, 54 (testimony of Prof. MacLachlan).

273. 112 CONG. REC. 13186-9 (daily ed. June 21, 1966).

274. Authorities cited notes 257-68 *supra*.

275. Under another aspect of the Treasury proposal, there would have been no discharge of tax liabilities. Note 248 *supra*. Congress having determined generally to dis-

Congress also rejected the further recommendation of the Treasury and the Finance Committee that the law make clear that the dischargeability of claims for *penalties*, and their priority in those circumstances in which they are allowable, are governed by the same conditions as the underlying tax liability.²⁷⁶ The law refers only to "taxes," although there is substantial basis for the view that penalties, like interest, are assimilated to "taxes" for this purpose.²⁷⁷ Nevertheless, the existence of contrary authority makes it desirable to remove the doubt.²⁷⁸

2. *Tax Liabilities Becoming Payable During Administration*

Taxes incurred *after* the filing of a bankruptcy petition are treated

charge "stale" tax claims, some modification may be desirable for the case where the deferral of collection is pursuant to an agreement with the taxpayer.

276. H. REP. NO. 687, 89th Cong., 1st Sess. 7 (1965) (Treasury Dep't statement); S. REP. NO. 999, 89th Cong., 2d Sess. 20, 22 (1966). The proposal would have inserted after "taxes" in the discharge provision (11 U.S.C. § 35(a)(1) (Supp. II, 1965-66)) the words "(including, whether provable or allowable, any interest, additional amount, addition to tax, or assessable penalty)," and in the priority provision (11 U.S.C. § 104(a)(4) (Supp. II, 1965-66)) the words "(including any interest, additional amount, addition to tax or assessable penalty allowable under subdivision j of section 57 of this Act [11 U.S.C. § 93(j)]." With respect to interest, the proposal would merely be declaratory of the law as established in *Bruning v. United States*, 376 U.S. 358 (1964).

277. INT. REV. CODE OF 1954, §§ 6659(a) and 6671(a) provide that penalties "shall . . . be assessed and collected in the same manner as taxes," and that "any reference in this title [i.e., the Internal Revenue Code, but not necessarily the Bankruptcy Act] to 'tax' shall be deemed also to refer to penalties. The penalty imposed on an officer for failure to pay over a corporate employer's withholdings (*id.* § 6672) was accordingly held to be a "tax" for purposes of 11 U.S.C. § 35(a)(1) (before the 1966 amendment), in *Sherwood v. United States*, 228 F. Supp. 247, 250 (E.D. N.Y. 1964).

278. In *United States v. Mighell*, 273 F.2d 682 (10th Cir. 1959), discharge of fraud penalties was allowed because they were not deemed nondischargeable "taxes" within the meaning of former 11 U.S.C. § 35(a)(1). If *Mighell* is sound, the *three-year* rule of new § 35(a)(1) would in no event apply; but the question whether penalties are dischargeable in *all* cases or in *no* case would remain an open one, because of a hiatus in the Bankruptcy Act, which makes penalties (unless they make good a "pecuniary loss") not "allowable" (11 U.S.C. § 93(j) (1964)) but fails to state whether penalties of either category are "provable" (*id.* § 103). A debt which is "provable . . . , whether allowable in full or in part," is dischargeable unless it constitutes a tax, or unless some exception applies (*id.* § 35 (a) (Supp. II, 1965-66)). *Mighell* held that non-pecuniary-loss penalties were "provable" in full and, if assessed before bankruptcy, were "allowable" in part (to the extent of the property subject to lien), so were fully dischargeable. The second premise was overruled in *Simonson v. Granquist*, 369 U.S. 38 (1962), which held that such penalties are *not allowable* to any extent, even if assessed before bankruptcy and supported by a lien. Hence, if (as *Mighell* held) the penalty is not construed to be a "tax," it would seem not to be dischargeable regardless of age. Of course, even if deemed a "tax," fraud penalties would not be discharged in any event, because the underlying tax cannot be. 11 U.S.C. § 35(a)(1) (d) (Supp. II, 1965-66). In the case of "pecuniary loss" penalties, such as the officer's penalty referred to in note 277 *supra*, the Government has argued that the liability, although "allowable" (*id.* § 93(j)), is not "provable," and hence is not dischargeable. *Sherwood v. United States*, 228 F. Supp. 247, 250 (E.D. N.Y. 1964) (rejecting the argument but denying discharge on another ground, no longer applicable in all cases). (It may be noted that the same hiatus in the Bankruptcy Act may raise a question whether the tax liability itself, to the extent denied priority under 11 U.S.C. § 104(a)(4) as amended, is provable and allowable on a parity with general creditors. See 3 W. COLLIER, BANKRUPTCY ¶ 57.30 (14th ed. 1961).)

as administration expenses²⁷⁹ entitled to the highest priority, except against certain recognized liens,²⁸⁰ but on an equal footing with other administration expenses.²⁸¹ Unfortunately, it is easier to state the principle than to apply it, because "the provisions of the Bankruptcy Act are clear neither as to what constitutes a pre-bankruptcy tax claim subject to fourth priority status as distinguished from a post-bankruptcy tax claim, nor what the Government's rights are once a post-bankruptcy tax claim is established."²⁸²

In the case of taxes imposed on an annual basis, rather than on specific transactions, the courts have usually arbitrarily assigned the tax to the pre- or post-bankruptcy period on the basis of whether all the facts necessary to compute the tax were known or knowable before the filing of the petition.²⁸³ Thus, certain taxes which are incurred if business is done on any day of a year or if property is held on a specified day may be deemed pre-bankruptcy taxes, even though most of the year falls after the date of bankruptcy.²⁸⁴ Others, such as income and some franchise taxes, which cannot be computed until the year is completed, are arbitrarily considered to be post-bankruptcy taxes, even if bankruptcy occurred late in the year.²⁸⁵

279. *Security-First Nat'l Bank v. United States*, 153 F.2d 563 (9th Cir. 1946); *In re Fonda, J. & G. R. R.*, 126 F.2d 606 (2d Cir. 1942). The question whether a particular tax statute applies to a bankrupt estate is not here considered. *Cf.* 28 U.S.C. § 960; *United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959). However, see note 286 *infra*.

280. *In re Thornycroft, Inc.*, 120 F.2d 469 (2d Cir. 1941). Certain pre-bankruptcy tax liens are expressly postponed to administration expenses, and hence to taxes incurred during bankruptcy. 11 U.S.C. § 107(c)(3), *supra* note 107. And a post-bankruptcy tax may be preferred to an earlier lien on the theory of benefit to the lien. *United States v. Wasserman*, 257 F.2d 491 (1st Cir. 1958), discussed note 336 *infra*.

281. *United States v. Killoren*, 119 F.2d 364 (8th Cir. 1941); *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941); *Missouri v. Earhart*, 111 F.2d 992, 995 (8th Cir. 1940), *cert. denied*, 311 U.S. 676 (1940). Where a liquidating bankruptcy succeeds a rehabilitation proceeding under the Act, expenses (including taxes) of the later phase are now preferred. 11 U.S.C. § 104(a)(1) (Supp. II, 1965-66).

282. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 98 (3d Cir. 1964).

283. 3 W. COLLIER, BANKRUPTCY ¶ 64.405[1] (14th ed. 1961).

284. *New York v. Jersawit*, 263 U.S. 493 (1924); *New Jersey v. Anderson*, 203 U.S. 483, 494 (1906); *United States v. Goggin*, 123 F.2d 432 (9th Cir. 1941), *cert. denied*, 315 U.S. 804 (1942); *Massachusetts v. Meeham*, 67 F.2d 638 (1st Cir. 1933), *cert. denied*, 291 U.S. 666 (1934).

285. *First Nat'l Bank of Jacksonville v. United States*, 87 F.2d 896 (5th Cir. 1937); *In re International Match Co.*, 79 F.2d 203 (2d Cir. 1935), *cert. denied*, 296 U.S. 652 (1935). If the trustee steps into the bankrupt's tax position, as in the case of the federal corporate income tax (INT. REV. CODE of 1954, § 6012(b)(3); *United States v. Sampsell*, 266 F.2d 631 (9th Cir. 1959)), the tax for the full year becomes an expense of administration. See the *First Nat'l Bank* case, *supra*. But an individual's income tax for the year of bankruptcy (which might arise, for example, if he sold low-basis property at a gain) does not become a liability of the bankrupt estate, which took over the proceeds of the bankrupt's taxable activity (I.T. 3959, 1949-1 CUM. BULL. 90), but must be collected, if at all, from his exempt or after-acquired property. *In re Cooney*, 35 Am. Bankr. Rep. (n.s.) 247 (Ref. N.D.N.Y. 1938).

In contrast, the courts regard employment taxes as apportionable, drawing a line at the date of the petition, even if the taxable period ends thereafter and the return is required to be made by the trustee, standing in the shoes of the bankrupt.²⁸⁶ The tax attributable to *wages paid by the debtor* before bankruptcy is considered a pre-bankruptcy obligation, with the priority of a tax claim, not that of an administration expense.²⁸⁷ On the other hand, the taxes attributable to wages paid for services rendered to the bankrupt estate itself are clearly expenses of administration.²⁸⁸

The courts have encountered difficulty, however, with the taxes on wages *earned before* bankruptcy but distributed as wage dividends by the trustee. Only the *payment* of wages, not the incurring of liability therefore, renders an employer liable for the tax,²⁸⁹ so the tax obligation arises only after bankruptcy. Some courts, therefore, have mechanically determined that such taxes were administration expenses.²⁹⁰ More recently, however, the Third Circuit in *Connecticut Motor Lines*²⁹¹ has quite properly recognized that such taxes, attributable to pre-bankruptcy services and having nothing whatever to do with the "development, preservation or distribution" of the estate, are not in the nature of expenses of administration. But the court then had to indulge in some agile mental gymnastics to conclude that the liability was a tax "legally due and owing *by the bankrupt*,"²⁹² and hence entitled to fourth priority provided the tax collector timely filed a proof of claim.²⁹³

286. Despite the argument that the trustee stands in the shoes of a levying creditor, not of the bankrupt employer, and that he cannot conveniently ascertain the family status and other relevant facts with respect to employees who may have earned the wages long before (*see* referee's opinion, *In re Forest City Brewery* (N.D. Ohio 1948), *quoted in extenso* in Oglebay, *Some Developments in Bankruptcy Law*, 23 REF. J. 12, 14 (1948)), it is now well settled that the trustee must withhold and pay taxes with respect to wage dividends. *In re Connecticut Motor Lines*, 336 F.2d 96, 99 (3d Cir. 1964); *United States v. Curtis*, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950), *rev'g In re Forest City Brewery*, *supra*; *United States v. Fogarty*, 164 F.2d 26 (8th Cir. 1947).

287. *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955); *Pomper v. United States*, 196 F.2d 211 (2d Cir. 1952).

288. *Missouri v. Glick*, 135 F.2d 134 (8th Cir. 1943); *United States v. Killoren*, 119 F.2d 364 (8th Cir. 1941).

289. INT. REV. CODE of 1954, §§ 3102, 3111, 3202, 3221, 3301, 3402.

290. *Lines v. California Dept. of Employment*, 242 F.2d 201 (9th Cir.), *rehearing denied*, 246 F.2d 70 (9th Cir.), *cert. denied*, 355 U.S. 857 (1957); *United States v. Fogarty*, 164 F.2d 26, 33 (8th Cir. 1947).

291. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964).

292. 11 U.S.C. § 104(a)(4) (Supp. II, 1965-66).

293. Proof of claim for taxes must be filed within six months after the first date set for the first meeting of creditors, unless a reasonable extension is granted on timely application. 11 U.S.C. § 93(m) (1964).

based on the maximum *potential* tax that would become payable if and when the trustee paid all the pre-bankruptcy wages on the books.²⁹⁴

Additional complications arise when the tax is not one imposed on the employer himself, but one which he is required to collect or withhold from employees. The interpretative task is complicated by an ambivalent statute which prescribes that such taxes "shall be held to be a special fund *in trust* for the United States," but adds that "the amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions . . . as are applicable with respect to the *taxes* from which such fund arose."²⁹⁵ If the bankrupt complied with his statutory duty and segregated the withheld amounts, the Government can trace the trust fund and claim priority even over administration expenses.²⁹⁶ But if, as is common when bankruptcy impends, the employer simply paid net wages and set nothing aside for the tax, there is no traceable trust fund.²⁹⁷ In such circumstances, the claim enjoys fourth priority as a *tax*, since the courts have rejected both the view that the Government is entitled to second priority as a statutory assignee of the wage claimants from whose wages the amounts were deducted and not paid over,²⁹⁸ and the view that the claim should have only fifth priority as a non-tax debt owed to the United States by a collection agent.²⁹⁹

294. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 105-07 (3d Cir. 1964).

295. INT. REV. CODE of 1954, § 7501(a) (emphasis added).

296. *In re States Motors, Inc.*, 168 F. Supp. 82 (E.D. Mich. 1958). See also *City of Dallas v. Crippen*, 171 F.2d 526, 529 (5th Cir. 1959). Administration expenses beneficial to the trust fund may be preferred, however. *In re S. T. Foods, Inc.*, 202 F. Supp. 37, 40 (S.D.N.Y. 1962).

297. *In re Independent Automobile Forwarding Corp.*, 118 F.2d 537, 539 (2d Cir. 1941), *rev'd on other grounds sub nom.* *United States v. New York*, 315 U.S. 510 (1942); *In re Allied Elec. Prods., Inc.*, 194 F. Supp. 26, 31 (D.N.J. 1961); cf. *McKee v. Paradise*, 299 U.S. 119 (1936).

298. *In re Vogue Bag Co.*, 60-1 U.S.T.C. ¶ 9116 (Ref., E.D.N.Y. 1959). The court relied on *Local 140 Security Fund v. Hack*, 242 F.2d 375 (2d Cir. 1957), *cert. denied*, 335 U.S. 833 (1957) (which was confirmed in *United States v. Embassy Restaurant*, 359 U.S. 29 (1959)), holding welfare fund contributions not to be wage claims under 11 U.S.C. § 104(a)(2). Those welfare payments, however, were not deducted from wages. *Voluntary wage deductions* have been treated as wage claims in bankruptcy (*In re Ross*, 117 F. Supp. 346 (N.D. Calif. 1953)), on the principle which so treats the claims of assignees of wages. *Shropshire, Woodliff & Co. v. Bush*, 204 U.S. 186 (1907). Although involuntary, the withholding of taxes from wages satisfies an obligation of the wage earner with respect to such wages. INT. REV. CODE of 1954, §§ 31, 3101. Nevertheless, the "statutory assignment" theory of withheld taxes has not, in other contexts, found favor with the courts. *Central Bank v. United States*, 345 U.S. 639, 645 (1953); *United States v. Crosland Constr. Co.*, 217 F.2d 275 (4th Cir. 1954); *United States Fidelity & Guar. Co. v. United States*, 201 F.2d 118, 120 (10th Cir. 1952). See INT. REV. CODE of 1954 § 3307, treating the amount deducted as having been *paid* to the employee at the time of the deduction, thus leaving only an obligation from the employer to the Government outstanding.

299. *United States v. New York*, 315 U.S. 510, 513-16 (1942), reversing the Court of

In the case of taxes required to be withheld by the trustee or by a debtor in possession *during the period of administration*, a number of decisions have allowed "trust fund" priority even where no segregated fund could be traced, on the theory that the entire estate is administered in trust under the supervision of the bankruptcy court, and that no advantage should be taken of the failure of an officer of the court to perform his duty to segregate the fund.³⁰⁰ The Third Circuit, however, has dismissed the argument out of hand, holding that since the "trust fund" is required to be collected in the same manner as a tax,³⁰¹ it is entitled to no higher priority.³⁰² Dicta by the Supreme Court and the Eighth Circuit have also indicated that the doctrine is none too firmly established, in view of the "strong policy . . . that places all expenses of administration on a parity, including claims for taxes."³⁰³

All such problems could be better resolved if the statute were "more explicit in its commands" and did not leave the courts to deal with them in a "partial vacuum."³⁰⁴ I submit that the *Connecticut Motor Lines* decision provides the touchstone for revision of the rules to make the administration expense category include all those taxes actually attributable to the "development, preservation or distribution" of the estate, and exclude others which merely happen to have become "legally due and owing" after bankruptcy. But amendment of the other priority categories would then be required in order not to leave tax claims fairly attributable to pre-bankruptcy operations in limbo.

In the case of annual taxes,³⁰⁵ whether they technically accrue before or after bankruptcy, there should be an end to the "all or nothing"

Appeals on this point. See 3 W. COLLIER, BANKRUPTCY ¶ 64.405[2.2] (14th ed. 1961).

300. *In re Airline-Arista Printing Corp.*, 156 F. Supp. 403 (S.D.N.Y. 1957), *aff'd*, 267 F.2d 333 (2d Cir. 1959); *Hercules Serv. Parts Corp. v. United States*, 202 F.2d 938 (6th Cir. 1953); *United States v. Sampsell*, 193 F.2d 154 (9th Cir. 1951). To the same effect with respect to local sales taxes, see *City of New York v. Rassner*, 127 F.2d 703 (2d Cir. 1942).

301. INT. REV. CODE of 1954, § 7501(a).

302. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 107 (3d Cir. 1964). See also *In re Green*, 264 F. Supp. 849 (D. Colo. 1967). Whether the claim would enjoy the status of an administration expense or a tax would depend on when the wages were earned or paid, and on the resolution of the conflict between the *Connecticut Motor Lines* case and *United States v. Fogarty*, 164 F.2d 26 (8th Cir. 1947), both of which involved withheld taxes as well as taxes imposed on the employer. See p. 274 *supra*.

303. *Nicholas v. United States*, 384 U.S. 678, 690-91 (1966); *United States v. Kalishman*, 346 F.2d 514, 520 (8th Cir. 1965), *cert. denied*, 384 U.S. 1003 (1966), both citing 3 W. COLLIER, BANKRUPTCY ¶ 64.02, at 2066, n.27 (14th ed. 1964). In both cases, the Government (having collected the principal) sought "trust fund" priority for its claim for interest thereon, which was held not allowable for other reasons, so the courts' comments were dicta.

304. *In re Connecticut Motor Lines*, 336 F.2d 96, 108 (3d Cir. 1964).

305. See authorities cited notes 283-285 *supra*.

notion that they are unapportionable.³⁰⁶ They can readily be apportioned if the law so prescribes.³⁰⁷ Therefore, the amount fairly attributable to the pre-bankruptcy period (on the basis of elapsed time or separate accounting, whichever is appropriate in the circumstances) should be allowable as a tax claim, and the balance should be treated as a post-bankruptcy obligation, regardless of the accrual date.³⁰⁸ Employment taxes similarly should rank as administration expenses only to the extent that they relate to wages earned during administration, without regard to when the wages were *paid* and the tax was incurred.³⁰⁹

The status of withholding tax claims requires close analysis in the light of bankruptcy policies. The following may at least be suggestive of the course to follow:

(a) Taxes withheld from wages earned and paid prior to bankruptcy should continue to be treated as at present. If the bankrupt segregated the funds withheld, that is equivalent to payment before bankruptcy and the trust fund should be respected. If he did not, the obligation is like any other unpaid tax claim. Although it originated in the pay-

306. In *Segal v. Rochelle*, 382 U.S. 375, 380 (1966), in holding the trustee entitled to the benefit of an income tax refund based on the carryback of a loss incurred for the year during which bankruptcy occurs (and noting the lower court's suggestion that, if losses had been incurred in both the pre-bankruptcy and post-bankruptcy portions of the year, the benefit of the carryback might be *apportioned* between the trustee and the individual debtor), the Court referred to the right to refund as "rooted in the pre-bankruptcy past." So also are the *obligations* for taxes fairly attributable to the elapsed portion of the year, even if not technically accrued or determinable until after bankruptcy.

307. For example, although property taxes technically accrue on a specific date rather than ratably through the year (*Magruder v. Supplee*, 316 U.S. 394, 399 (1942); *Doric Co. v. Commissioner*, 341 F.2d 967 (9th Cir. 1965)), Congress has permitted or required their apportionment for various income tax purposes. INT. REV. CODE of 1954, §§ 164(d), 461(c); *Tennessee Life Ins. Co. v. Phinney*, 280 F.2d 38 (5th Cir. 1960) (under § 45 of 1939 Code, predecessor of § 482 of 1954 Code). Apportionment of such taxes was indicated, in a bankruptcy setting, in *Hennepin County v. Savage Factories*, 83 F.2d 453 (8th Cir. 1936).

308. The income of the year of bankruptcy ought to be apportioned, for income tax purposes, according to whether the trustee or the bankrupt is entitled to collect it. Hence, income accrued before but becoming taxable after the date of bankruptcy, according to the taxpayer's accounting method, should be treated as pre-bankruptcy income. Cf. *Helvering v. Enright*, 312 U.S. 636 (1941). The year should, however, be treated as a single taxable period, for which one tax computation is made and apportioned (perhaps, however, dividing the responsibility for supplying the information necessary for the computation). The post-bankruptcy portion of the obligation may be an administration expense if the trustee steps into the tax shoes of the bankrupt, or an individual liability if he does not (as in the case of the individual income tax). See note 285 *supra*. In the case of certain franchise taxes, it may be necessary to permit payment of the full liability (and even of a prior year's liability) as an administration expense, if the estate would be unable to do business if the tax were not paid. *Michigan v. Michigan Trust Co.*, 286 U.S. 334 (1932); *Thompson v. Louisiana*, 98 F.2d 108 (8th Cir. 1938). See *Pomper v. United States*, 196 F.2d 211, 212 (2d Cir. 1952). Priorities fade in importance when payment is a condition to exercise of an essential privilege. Cf. *United States v. California*, 281 F.2d 726 (9th Cir. 1960).

309. See p. 274 & notes 289-91 *supra*.

ment of wages, the wage transaction was closed when the net payment was made to employees, and the social policy that dictated granting priority to wages has no relevance to the amount remaining unpaid to the tax collector.³¹⁰

(b) Taxes withheld from wage dividends, paid during bankruptcy on wages earned before bankruptcy, should have the same rank as the wages themselves, and should not be classified either as trust funds, administration expenses or tax claims.³¹¹ If \$1,000 is owed to an employee, covering a period of three months or less, \$600 of the *gross* wage should enjoy second priority and \$400 should be a general claim;³¹² and the obligation of the trustee (or debtor in possession) is to pay, say, 80 per cent thereof to the employee and 20 per cent to the tax collector. The tax claim is a derivative one; and since the wage transaction has not already been closed by a net payment to the employee, it makes no sense to assign to the "withheld" amount either a higher or lower priority than the sum out of which it was carved.

(c) Taxes withheld from wages earned during administration should, like the wages themselves, rank as administration expenses, but not as trust funds.³¹³ The need to choose between those categories arises only if the estate proves insufficient to satisfy all administration expenses, and the derivative nature of the tax claim affords a guide to the solution. Suppose, for example, that there is \$3,000 in the estate, and administration expenses amount to \$5,000, including wages of \$2,000. There being no priority ranking among administration expenses,³¹⁴ 60 per cent of the wages, or \$1,200, would be payable, from which a tax of, say, \$240 should be deducted and paid in full to the tax collector.³¹⁵ If, on the other hand, the wages had been paid as earned, in the amount of \$2,000 less withholding of, say, \$400, the \$1,600 net payment would leave \$1,400 for application on the \$2,400 of other expenses (including the obligation for \$400 taxes withheld). The wages then have been overpaid, for which the remedy is to surcharge the trustee (if there is one) in appropriate circumstances³¹⁶ or to recover the overpayments

310. Authorities cited note 298 *supra*.

311. See p. 276 & notes 300-03 *supra*.

312. If it is thought unduly burdensome to reduce the employee's \$600 priority by the tax thereon, the fault lies in the unrealistic \$600 limitation, which was set in a very different economic age and ought to be reconsidered.

313. See p. 276 & notes 300-03 *supra*.

314. Authorities cited note 281 *supra*.

315. The tax being carved out of the wage payment, already reduced to 60 per cent of the liability, there would be no occasion to reduce the tax payment to 60 per cent thereof.

316. *In re Lambertville Rubber Co.*, 111 F.2d 45 (3d Cir. 1940). The problem has arisen where there was no trustee but a debtor in possession. See note 300 *supra*.

from the recipients if that is feasible.³¹⁷ It only compounds the error to give the taxes preferred treatment *as if* they had been set aside in trust; for the tax itself would be recoverable (at least by offset) if a disproportionate amount had been paid over³¹⁸ and hence also if it had been merely segregated. If the overpaid wages cannot be recovered from the trustee or the employees, the Government should take potluck with the other obligees of administration expenses in the distribution of the depleted fund.

When taxes for periods ending after bankruptcy, or based upon subsequent transactions such as the payment of wage dividends, are treated as *other than* administration expenses, a procedural duplication results. Although the trustee will be required to file a tax return when the liability ultimately matures,³¹⁹ the law also literally requires that the tax collector anticipate the event by filing a proof of claim, within a six-month time limit (or "reasonable fixed extension" thereof),³²⁰ for any tax which will not constitute an expense of administration.³²¹ Hence, in *Connecticut Motor Lines* the court's sound conclusion that the tax on the wage dividend was not an administration expense compelled the further conclusion that the Government had forfeited its rights by not putting in a proof of claim (estimated on the assumption that all unpaid wages would be paid), months before it could be known how much of the wages would be paid or what the tax rate would be when that occurred.³²² The law should not insist upon a duplication of documents, where one of them is only an "empty formality."³²³ There may be circumstances in which the trustee's difficulties in assembling information concerning events antedating his appointment should be given recognition, either in more liberal provisions for extensions of time or by placing the initial burden on the tax collector;³²⁴ and others,

317. *Leonard v. Gage*, 94 F.2d 19, 24 (4th Cir.), *cert. denied*, 303 U.S. 653 (1938); *cf.* *City of New York v. Rassner*, 127 F.2d 703, 707 (2d Cir. 1942).

318. *In re Wil-Low Cafeterias, Inc.*, 35 F. Supp. 965 (S.D.N.Y. 1940).

319. *Nicholas v. United States*, 384 U.S. 678, 693 (1966).

320. 11 U.S.C. § 93(n) (1964).

321. Taxes constituting administration expenses are not required to be proved as claims under 11 U.S.C. § 93(n) (*In re California Pea Prods., Inc.*, 37 F. Supp. 638 (S.D. Cal. 1941)), although they may be lost if neither reported by the trustee nor demanded by the tax collector before the proceeding is closed. *McColgan v. Maier Brewing Co.*, 134 F.2d 385 (9th Cir. 1943), *cert. denied*, 320 U.S. 737 (1943). See 2 W. COLLIER, *BANKRUPTCY* ¶ 47.08 (14th ed. 1966); 3 *id.* ¶ 62.14, at 1529 n.82 (14th ed. 1961); Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141, 1175 (1942).

322. *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964).

323. See *Nicholas v. United States*, 384 U.S. 678, 699 (1966) (dissenting opinion).

324. *Id.* at 699-701, noting that no more than a 15-day extension was legally obtainable for filing a withholding tax return due shortly after the trustee took office. See also the

such as the wage dividend tax situation, where the trustee is well able to file the return when the events occur, and it is the anticipatory estimated proof of claim by the collector that is an "empty formality." Some practical accommodation to the exigencies of both parties is called for.

Unemployment taxes that fall due during bankruptcy, whether relating to the period before or after the petition, give rise to a problem of another kind. A credit equal to 90 per cent of the federal unemployment tax is allowed for contributions made to a state unemployment insurance system.³²⁵ However, the employer loses 10 per cent of the credit otherwise allowable if he fails to make such contribution on or before the due date of the federal tax.³²⁶ Although Congress has decreed that no part of the federal tax, even if the credit is denied or reduced, shall be deemed a penalty for purposes of the Bankruptcy Act,³²⁷ the practical effect is to penalize the bankrupt estate for its sometimes unavoidable inability to pay its taxes on time. When there is uncertainty whether the estate will be able to pay all claims of the same class, the trustee risks surcharge if to spare the estate loss of credit he makes timely payment of the state unemployment contribution.³²⁸ Since the delay is "necessitated by law if the courts are properly to preserve and protect the estate for the benefit of all interests involved,"³²⁹ the purpose of reducing the credit (to induce prompt payment into the state fund) is inoperative and there is no justification for reducing the credit in such cases.³³⁰

referee's opinion in *In re Forest City Brewery*, *supra* note 286, regarding the practical problems of the trustee. Concerning penalties for not filing, see notes 344-351 *infra*.

325. INT. REV. CODE of 1954, § 3302(a). The credit is limited to 90 percent of 3 percent of taxable wages, even when the federal tax exceeds 3 per cent. Credit may also be allowed for amounts *not* contributed, where the employer merits a reduced rate. Concerning the priority problem created by the interrelationship of the state and federal liabilities, see Part IV.C.3 in the second installment of this article.

326. INT. REV. CODE of 1954, § 3302(a)(3).

327. Social Security Act Amendments of 1939, ch. 666, § 902(i), 53 Stat. 1360, 1400. See also *United States v. New York*, 315 U.S. 510, 516-517 (1942).

328. *In re Lambertville Rubber Co.*, 111 F.2d 45 (3d Cir. 1940); *Massachusetts v. United States*, 333 U.S. 611, 613 (1948).

329. *Vanston Bondholders Comm. v. Green*, 329 U.S. 156, 163 (1946). "The control of the bankruptcy court should be a satisfactory guaranty that tax law will be complied with as strictly as circumstances may permit. But it is preposterous for taxing agencies to penalize an insolvent estate for the mere fact that it is insolvent, the very reason for which it is in the hands of the court." Wurzel, *supra* note 321, at 1176.

330. Before 1939, the *entire* credit was lost if payment was a day late. Section 609 of the Social Security Act Amendments of 1939, for the first time allowed 90 per cent of the credit if payment was made by June 30, and none if payment was later. But it also provided that *no* loss or reduction of credit on account of late payment should occur "if such taxpayer's assets, at any time during the period from such last day for filing a return for such year to June 30 next following such last day, both dates inclusive, are in the

Finally, *real property taxes* incurred during bankruptcy³³¹ may still create the very circular priority problem which Congress sought to overcome in the Federal Tax Lien Act of 1966. The problem, described and illustrated in Part I,³³² arises when a mortgage has priority over a federal tax lien, which has priority over a later real property tax, which has priority under state law over the mortgage. It was formerly resolved at the expense of the mortgagee, by setting aside the amount of the mortgage, applying the balance on the federal tax, and taking the property tax out of the amount set aside for the prior mortgagee. The Tax Lien Act grants a superpriority to *liens* for real property taxes,³³³ thereby enabling the *full* amount of the mortgage to be satisfied, next after the property tax lien, before anything is applied on the federal tax lien. A property tax incurred during bankruptcy, however, cannot give rise to a *lien* against the estate,³³⁴ but ranks as an administration expense, subordinate to duly filed federal tax liens valid against the trustee;³³⁵ and the superpriority provision is literally inapplicable if the property tax does not become a lien. Yet the property tax may nevertheless be preferred over the mortgage, and the old circular priority solution may be applied.³³⁶ The Bankruptcy Act should

custody or control of a receiver, trustee, or other fiduciary appointed by, or under the control of, a court of competent jurisdiction." 53 Stat. 1360, 1987-88. Congress eliminated that relief in Section 601 of the Revenue Act of 1943, saying it "does not appear to be warranted" in view of the further amendment then made, by which 90 per cent of the credit could be earned no matter how late the payment might be made. H.R. REP. NO. 871, 78th Cong., 1st Sess. 73 (1943); S. REP. NO. 627, 78th Cong., 1st Sess. 96 (1943). But a small penalty for a delay necessitated by law is no more warranted than a large one. The exception (with the reference to June 30 deleted) should be reenacted.

331. The property of the bankrupt estate is subject to such taxes. *Swarts v. Hammer*, 194 U.S. 441 (1904). See also 28 U.S.C. § 960 (1964).

332. P. 231-32 *supra*.

333. INT. REV. CODE OF 1954, § 6323(b)(6)(A).

334. Cf. *McColgan v. Maier Brewing Co.*, 134 F.2d 385, 388 (9th Cir. 1943); *In re Lambertville Rubber Co.*, 111 F.2d 45, 48 (3d Cir. 1940); *Lockhart v. Garden City Bank & Trust Co.*, 116 F.2d 658, 661 (2d Cir. 1940). See also 11 U.S.C. § 107(c)(2) (Supp. II, 1965-66), providing that a lien invalid against the trustee shall be invalid against all liens indefeasible in bankruptcy (here, the federal lien, which would otherwise be subordinate to the later real property tax). But cf. *Berryhill v. Gerstel*, 196 F.2d 304 (5th Cir. 1952) (treating real property taxes, incurred during a Chapter X proceeding, as *liens* surviving against the reorganized corporation).

335. As against real property, the filed federal tax lien is generally superior to administration expenses, including property taxes. *County of Clark v. United States*, 284 F.2d 885 (9th Cir. 1960).

336. Notwithstanding the second proviso in 11 U.S.C. § 104(a)(4), the property tax must be satisfied as an administration expense, and not at the expense of the mortgagee, if funds are sufficient. *Robertson v. Goree*, 29 F.2d 261 (5th Cir. 1928). (But if there is no personal liability for the property tax, see *Northumberland County v. Philadelphia & Reading Coal & Iron Co.*, 131 F.2d 562 (3d Cir. 1942).) If, however, the amount remaining after the prior liens of the mortgage and the federal tax is insufficient, the property tax must be satisfied at the expense of one of them. In *United States v. Wasserman*, 257 F.2d 491 (1st Cir. 1958), real property taxes accruing during bankruptcy were preferred over a prior mortgage, as administration expenses beneficial to the mortgagee, on the theory

make clear that a real property tax is an administration expense which is beneficial to, and hence may be satisfied at the expense of, an antecedent federal tax lien.³³⁷

3. *Penalties and Interest Accruing During Bankruptcy*

"The bankruptcy laws do not favor saddling an estate with penalties."³³⁸ Those penalties which accrue before the filing of the petition are expressly disallowed, except to the extent that they make good an actual pecuniary loss sustained.³³⁹ That policy is so strong that it is carried to the point of disallowing a lien,³⁴⁰ a judgment³⁴¹ or a levy³⁴² that arose from an underlying penal obligation. The policy reflects the "broad aim of the [Bankruptcy] Act to provide for the conservation of the estates of insolvents to the end that there may be as equitable a distribution of assets as is consistent with the type of claims involved. . . . Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors."³⁴³

Quite the opposite policy prevails, however, if the penalty is incurred in the course of the bankruptcy proceeding, whether resulting from negligence or misconduct of the trustee or from the restraints imposed by the proceeding itself.³⁴⁴ On the ground that the trustee was (or at least could have been) selected by the creditors³⁴⁵ and is acting for their

that, absent bankruptcy, the mortgage would have been subordinated to the property tax. But the intervening federal tax lien was preferred over the property tax, resulting in circular priority.

337. This result, in the light of the Federal Tax Lien Act of 1966, would be a natural extension of the rationale of *United States v. Wasserman*, 257 F.2d 491 (1st Cir. 1958), and might perhaps be reached by the courts unaided, since (absent bankruptcy) the property tax would have reduced the sum available for the federal tax lien before it impaired the mortgagee's position. Under that principle, the federal tax should be a general claim subrogated to the priority of the real property tax (as an administration expense), to the extent that the latter impaired the federal lien. *Id.* at 494 n.3.

338. *Nicholas v. United States*, 384 U.S. 678, 697 (1966) (dissenting opinion).

339. 11 U.S.C. § 93(j) (1964).

340. *Simonson v. Granquist*, 369 U.S. 38 (1962).

341. *In re Abramson*, 210 F. 878 (2d Cir. 1914).

342. *In re Brewster-Raymond Co.*, 344 F.2d 903 (6th Cir. 1965).

343. *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962) (footnote omitted).

344. *Nicholas v. United States*, 384 U.S. 678, 692-695 (1966) (failure of trustee to file return, soon after taking office); *Boteler v. Ingels*, 308 U.S. 57 (1939) (delinquency in paying vehicle license fees, where it was uncertain that the estate would be sufficient to pay all expenses entitled to share equally); *In re Chicago & N.W. Ry.*, 119 F.2d 971 (7th Cir. 1941) (delinquency after bankruptcy, in paying tax incurred before bankruptcy); cf. *California State Board of Equalization v. Goggin*, 183 F.2d 489 (9th Cir.), *cert. den.*, 340 U.S. 891 (1950).

345. 11 U.S.C. § 72(a) (1964). See *In re Samuel Chapman, Inc.*, 67-1 U.S. Tax Cas.

benefit,³⁴⁶ the “innocent creditors” are made to suffer the punishment which the law prescribes for the acts or defaults of their agent,³⁴⁷ unless the circumstances of his act and the financial condition of the trustee are such that they can recoup their loss through a surcharge.³⁴⁸ The thought is that if a tax is payable by the estate, the Government should not “be denied the traditional and almost universal method of enforcing” compliance.³⁴⁹ Yet the trustee is also an officer of the court, and “if it is unlawful to penalize the creditors for the delinquencies of the *debtor*, it is hard to see why they should be held accountable for an omission on the part of the trustee who in every act of his administration is under the direct surveillance of the court, and is not subject to the creditors’ instructions.”³⁵⁰

Congress should consider whether it would not be better to rely upon the procedures and where appropriate the disciplinary powers of the bankruptcy court, rather than upon the “almost universal method” of enforcing compliance by those who are not thus subject to court control and supervision. “The control of the bankruptcy court should be a satisfactory guaranty that tax law will be complied with as strictly as circumstances may permit.”³⁵¹

A similar dichotomy exists with respect to interest on tax liabilities. Not as “a matter of legislative command or statutory construction, but rather, [as] a fundamental principle of the English bankruptcy system which we copied,” interest on *pre-bankruptcy* taxes stops running against the estate at the date of the petition.³⁵² The theory is that since

¶ 9209 (Ref., S.D.N.Y. 1967), *confirmed*, 270 F. Supp. 1021 (S.D.N.Y. 1967). The Supreme Court has avoided opinion whether a penalty incurred by a *debtor* in possession would be collectible from the estate in a superseding liquidation. *Nicholas v. United States*, 384 U.S. 678, 694, n.28 (1966). See 11 U.S.C. §§ 638(3), 781(3) (1964). The *Chapman case*, *supra*, disallows the penalty.

346. *Ingels v. Boteler*, 100 F.2d 915, 918-919 (9th Cir. 1938), *aff'd*, 308 U.S. 57 (1939); *cf. In re I. J. Knight Realty Corp.*, 370 F.2d 624, 629 (3d Cir. 1967) (dissenting opinion), *cert. granted sub nom. Reading Co. v. Brown*, 36 U.S.L.W. 3157 (U.S. Oct. 16, 1967) (“creditors, for whom the business is being operated as if they were stockholders”).

347. It is anomalous that, while punitive sanctions for acts of the trustee, involving no “pecuniary loss” to the government, may be visited upon the creditors, the bankrupt estate has recently been held immune from tort liability for actual damage suffered by others through the trustee’s negligence, on the grounds that the outlay is not “proximately related to the preservation of the estate and . . . reasonably anticipated as a cost of operating the business.” *In re I. J. Knight Realty Corp.*, 370 F.2d 624, 628 (3d Cir. 1967).

348. *Delaware v. Irving Trust Co.*, 92 F.2d 17, 19 (2d Cir.), *cert. denied*, 302 U.S. 754 (1937).

349. *Boteler v. Ingels*, 308 U.S. 57, 61 (1939). See also *Nicholas v. United States*, 384 U.S. 678, 694 (1966).

350. Wurzel, *supra* note 321, at 1167-68 (emphasis added). See *Urban Properties Corp. v. Benson, Inc.*, 116 F.2d 321 (9th Cir. 1940); General Orders in Bankruptcy, Order 29.

351. Wurzel, *supra* note 321, at 1176. See *Blakistone v. State*, 117 Md. 237, 244-45, 83 A. 151 (1912).

352. *City of New York v. Saper*, 336 U.S. 328, 330 (1949). Such interest, however, survives

"some of the debts might carry a high rate [of interest] and some a low rate, . . . inequality would result in the payment of interest which accrued during the delay incident to collecting and distributing the funds. As this delay was the act of the law, no one should thereby gain an advantage or suffer a loss."³⁵³

On the other hand, under a considered dictum of the Supreme Court, interest does run during the bankruptcy period on those taxes which are incurred *during* that period and constitute administration expenses.³⁵⁴ The distinction may perhaps be supported on the theory that interest is denied only if the assets are insufficient to pay in full all claims of *equal dignity*, but should be allowed on interest-bearing administration expenses before any claims of lesser priority are paid.³⁵⁵ That reasoning, however, has not persuaded the courts that interest should be allowed on taxes which became liens before bankruptcy, and thus enjoy the highest priority of all.³⁵⁶

Realistically, "whether the tax accrued before bankruptcy or subsequent thereto, the evil propagated by continually accruing interest remains the same. In neither case is it logical to charge a bankrupt estate a fee for the use of money when it is the force of law which prevents the return of the principal to the creditor, rather than the desire of the debtor to retain its use."³⁵⁷ "If interest is allowed a secured creditor [or here, a first priority claimant] during the bankruptcy proceeding, . . . payment must come from assets which would normally go to the remaining creditors. Delay in the termination of the bankruptcy proceedings would diminish the shares of general creditors through no fault of

as a liability of the bankrupt (*Bruning v. United States*, 376 U.S. 358 (1964)), unless discharged under amended 11 U.S.C. § 35(a)(1).

353. *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266 (1914).

354. In *Nicholas v. United States*, 384 U.S. 678, 682-690 (1966), the Court concluded that "A tax incurred within any one of these three periods [the pre-arrangement period, the period of a Chapter XI arrangement, and the liquidating bankruptcy period] would, we think, be entitled to bear interest against the bankrupt estate until, but not beyond, the period in which it was incurred." *Id.* at 686. It was dictum for present purposes since the tax was incurred in the arrangement period, but the interest accrued only in the liquidating period, and was disallowed.

355. See *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 266-67 (1914); cf. *Nicholas v. United States*, 384 U.S. 678, 687-88 (1966). Consistently with that concept, interest has been denied on *post-bankruptcy* taxes when the estate was insufficient to pay administration expenses in full. *Missouri v. Earhart*, 111 F.2d 992, 996-97 (8th Cir.), *cert. denied*, 311 U.S. 676 (1940).

356. *In re Kerber Packing Co.*, 276 F.2d 245 (7th Cir. 1960); *United States v. Mighell*, 273 F.2d 682 (10th Cir. 1959); *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959); *United States v. Harrington*, 269 F.2d 719 (4th Cir. 1959). *Contra*, *In re Parchem*, 166 F. Supp. 724, 729 (D. Minn. 1958).

357. *United States v. Kalishman*, 346 F.2d 514, 520 (8th Cir. 1965), *cert. denied*, 384 U.S. 1003 (1966).

theirs.”³⁵⁸ The Supreme Court itself has not hesitated to deny interest on a post-bankruptcy item in some circumstances, based on “a balance of equities between creditor and creditor,”³⁵⁹ and Congress should carefully weigh the equities in the present situation.³⁶⁰

III. Federal Mortgages and Federal Non-Tax Liens

The mandate of the American Bar Association’s Special Committee on Federal Liens was, as its name indicates, not limited to *tax* liens.³⁶¹ Nevertheless, because of limitations of time and personnel, and the practical desirability of focusing its negotiations on one government department and one committee in each branch of Congress, the Special Committee’s final proposals, and to a greater extent the legislation which evolved, dealt primarily with the tax situation, leaving to another day the extension of the reforms to other areas.³⁶²

It is time now to focus on those areas, for many of the inequities and other problems of priorities and procedure with which the Federal Tax Lien Act of 1966 dealt may be mirrored in the case of federally held mortgages and other non-tax liens.³⁶³

A. Priorities

The decisions on federal tax liens prior to the reform legislation have become precedents for a developing “federal common law” of priorities, governing not merely those mortgages which arise directly from

358. *United States v. Harrington*, 269 F.2d 719, 723 (4th Cir. 1959). *See also* *Beecher v. Leavenworth State Bank*, 192 F.2d 10, 14 (9th Cir. 1951).

359. *Vanston Bondholders Comm. v. Green*, 329 U.S. 156, 165 (1946) (denying interest payable by contract on mortgage bond interest which accrued and was unpaid during bankruptcy).

360. It was said in *Nicholas v. United States*, 384 U.S. 678, 687 (1966), that the allowance of interest on debts incurred during the proceedings promotes the availability of capital to the estate—an end which, however, could readily be served by permitting the court to approve contracts for the payment of interest on funds borrowed by or credit extended to the estate, without subjecting the estate to interest on tax claims. If it appears in a particular case that payment of taxes was delayed, not because of doubt that funds would suffice to pay all claims of equal priority, but because the tax money was working for the rehabilitation of the debtor and the enhancement of the return to creditors, the court might be given discretion to allow interest—whether the tax liability arose before or after bankruptcy. *Id.* at 684; *cf.* *Sexton v. Dreyfus*, 219 U.S. 339, 346 (1911); *Beecher v. Leavenworth State Bank*, 192 F.2d 10, 14 (9th Cir. 1951).

361. 83 A.B.A. REP. 687, 838 (1958).

362. 84 A.B.A. REP. 645, 671 (1959).

363. For a detailed discussion, see Comment, *The Relative Priority of Small Business Administration Loans: An Unreasonable Extension of Federal Preference?* 64 MICH. L. REV. 1107 (1966). Another aspect of the problem, arising when insolvency brings Rev. Stat. § 3466 into operation, is dealt with in Part II.A, *supra*.

the sale of federal property³⁶⁴ or from federal loans,³⁶⁵ but also those mortgages which, on the face of the public records, are private transactions, and which become federally held mortgages only as a result of the satisfaction of an insurance, guarantee or participation arrangement.³⁶⁶ The priorities of liens for judgments on unsecured loans made or guaranteed by the United States may also be subject to that "federal common law."³⁶⁷

Private financial and business transactions operate under a diversity of lien priority rules, for which the basic rule that "the first in time is the first in right" is only a point of departure. Some liens, such as mechanics' liens, although not perfected until later, "relate back" to an earlier time such as commencement of the work. Others, such as liens for property taxes and sometimes liens for the price of work which enhances the value of the property, are preferred even over mortgages and other private interests perfected long before the event giving rise to such liens. Lenders and prospective lienors contract, and measure their margins of safety, with reference to those diverse rules.

The "federal common law" developed in the federal tax lien cases, however, is much "simpler." The universal rule, unless expressly modified by Congress, is that "the first in time is the first in right," to which

364. *United States v. Ringwood Iron Mines, Inc.*, 251 F.2d 145 (3d Cir.), *cert. denied*, 356 U.S. 974 (1958); *cf. New Brunswick v. United States*, 276 U.S. 547 (1928). A federal mortgage may also arise from a tax claim, where the taxpayer gives security in order to stave off more drastic collection action. *See* Treas. Reg. § 301.7101-1(b)(2); *Empire State Collateral Co. v. Bay Realty Corp.*, 232 F. Supp. 330 (E.D.N.Y. 1964).

365. *United States v. Oswald & Hess Co.*, 345 F.2d 886 (3d Cir. 1965); *In re Lehigh Valley Mills, Inc.*, 341 F.2d 398 (3d Cir. 1965); *United States v. County of Iowa*, 295 F.2d 257 (7th Cir. 1961); *United States v. Roessling*, 280 F.2d 933 (5th Cir. 1960); *Southwest Engine Co. v. United States*, 275 F.2d 106 (10th Cir. 1960); *United States v. Latrobe Constr. Co.*, 246 F.2d 357 (8th Cir.), *cert. denied*, 355 U.S. 890 (1957).

366. *W. T. Jones & Co. v. Foodco Realty, Inc.*, 206 F. Supp. 878, 882-86 (W.D. Va. 1962), *aff'd on other grounds*, 318 F.2d 881 (4th Cir. 1963). In the related area of federal priorities in insolvency proceedings (discussed in Part II.A *supra*), it is established that such derivative rights are protected to the same extent as the security for direct federal loans, if the government acquires a direct interest in the loan before insolvency. Authorities cited notes 130-132 *supra*.

367. *Jamaica Sav. Bank v. Morgan*, 226 F. Supp. 668 (E.D.N.Y. 1962). *Cf. Cape May County Sav. & Loan Ass'n v. Sebastian*, 93 N.J. Super. 77, 224 A.2d 703 (1966), where the record did not show that the judgment was assigned to the United States pursuant to a guarantee under any federal program, and the court, without disapproving the foregoing cases, rejected the Government's argument that "federal law will always apply to federal liens regardless of their source," since it would permit "the federal government [to] effectively frustrate state policy by taking assignments of claims from non-preferred lien creditors . . . and asserting them as federal liens." But precisely that has been permitted, in insolvency and bankruptcy priority cases. Authorities cited notes 135-36 *supra*. The *Jamaica Savings Bank* doctrine is criticized in Mitchell, *The Choateness Doctrine—Both Unconscionable and Unconstitutional*, 38 CONN. B.J. 252 (1964), relying on 28 U.S.C. § 1962, which subjects federal judgment liens to state law. *See also Custer v. McCutcheon*, 283 U.S. 514 (1931).

is added the gloss that the lien competing with the federal lien must first have become "choate."³⁶⁸

One of the most unfair applications of the "choateness" doctrine formerly applied where federal tax liens were involved related to mechanics' liens, which were subordinated to federal liens arising during or even after completion of the work which enhanced the value of the lien property.³⁶⁹ Congress wisely renounced that advantage in the 1966 Act by protecting a mechanics' lien against federal tax liens of which notice was not duly filed before the date as of which the mechanics' lien becomes protected under state law against bona fide purchasers, or the time when the lienor himself began to furnish services, labor or materials, if that is later.³⁷⁰ Thus, while Congress did not fully accept state priority rules for mechanics' liens,³⁷¹ it did enable contractors, suppliers and others to protect themselves by searching for federal tax liens before they become deeply involved. Yet if the courts apply the "choateness" doctrine of "federal common law," in pristine rigor, to the priorities of federally held mortgages and non-tax liens, it can result in inequities to mechanics' lienors fully comparable to those which Congress has seen fit to remedy in the related area.³⁷²

Although the growth of commercial financing involving a continuing series of loans on a revolving fund of inventories, receivables or other collateral was given recognition in the protections accorded such arrangements by the Uniform Commercial Code, "federal common law" lagged behind. Such security interests were, until 1966, treated as not "choate" when a federal tax lien intervened between the filing

368. Authorities cited notes 14-30 *supra*. Of the cases cited in notes 364-367 *supra*, applying such principles in non-tax cases, only the Third Circuit decisions in *Oswald & Hess* and *Lehigh Valley*, which subordinated state tax liens and liens for water and sewer charges, antedating the federal lien but not yet reduced to judgment, actually turned on application of the "choateness" doctrine as such. The others, while relying on the tax lien cases and using the language of "choateness," are supportable as applications of the unembellished "first in time" rule.

369. See note 24 *supra*.

370. See note 34 *supra*.

371. See Part IV.B.6, in the second installment of this article.

372. In the reported decisions involving a conflict between federally-held mortgages and mechanics' liens, the mortgages have antedated the work, and the court has had to go no further than to refuse to apply state laws which, to the extent of the added value, subordinated existing mortgages to mechanics' liens. *United States v. Latrobe Constr. Co.*, 246 F.2d 357 (8th Cir. 1957); *W. T. Jones & Co. v. Foodco Realty, Inc.*, 206 F. Supp. 878 (W.D. Va. 1962). Nevertheless, they use the "choateness" language of the federal tax lien decisions, and it may be supposed that they would likewise subordinate a mechanic's lien for work begun or completed before the execution of the mortgage. Note 363 *supra*. The latter result was in fact reached in an unreported case, although it was strongly influenced by the application of the insolvency priority statute, Rev. Stat. § 3466. *H. G. Agsten & Sons, Inc. v. West Virginia Industries Devel. Corp.* (S.D.W. Va. 1966), pending in 4th Cir. *sub nom.* *H. G. Agsten & Sons, Inc. v. Huntington Trust & Savings Bank*.

of a financing statement or agreement and the making of a particular advance or the acquisition of new collateral.³⁷³ Security for construction loans and even for future obligatory disbursements (*e.g.*, by a surety) was similarly vulnerable. Congress granted relief from the "choateness" rule in all those situations in the Federal Tax Lien Act of 1966, subject to specified conditions.³⁷⁴ Although no collision between those forms of financing and federally held mortgages and judgments has yet been reported in any case, the vast scope of federal loan and guarantee programs makes it only a question of time before such problems arise outside the federal tax lien field.

There is already evidence that government lawyers are attempting to extend a closely related application of the "choateness" doctrine to the non-tax lien field. The traditional real estate mortgage provides, validly under state laws, that if the mortgagor fails to pay property taxes or to keep the property repaired and insured, the mortgagee may pay for such items and add the amount of his outlays, as well as the cost of foreclosure, to the lien of his mortgage, with the same priority enjoyed by the principal and interest of the mortgage debt. Under the "federal common law," however, applied in federal tax lien cases until 1966, the mortgagee's lien for such expenditures was not "choate" until they were actually incurred, and intervening federal tax liens might prevent a prior mortgagee's being made whole.³⁷⁵ In a recent case involving the foreclosure of a private mortgage, which had priority over a judgment held by the Government as assignee, the Government contended that its judgment was superior under the "choateness" doctrine to the mortgagee's right to recover legal expenses and property taxes.³⁷⁶ Although the Government failed in that case because of peculiar facts, the court did not doubt the general applicability of the principle, and the threat is clear.

Quite apart from the "choateness" doctrine, problems and inequities can arise from the "first in time" rule itself in situations where state laws grant a superpriority. This is most evident in the case of real property taxes, which state laws almost universally prefer over pre-existing mortgages and liens on the theory that the tax is on the entire property, including all legal and equitable interests in it. The police and fire

373. Cases cited notes 27-28 *supra*.

374. Cases cited note 35 *supra*.

375. Cases cited note 29 *supra*. The rule was changed, as to federal tax liens, by new INT. REV. CODE of 1954, § 6323(e), aided (with respect to property taxes) by § 6323(b)(6).

376. Cape May County Sav. & Loan Ass'n v. Sebastian, 93 N.J. Super. 77, 224 A.2d 703 (1966).

protection, health and education facilities, water and sanitary and other services which state and local governments provide to residential and business properties and their occupants are the same whether or not the owner owes federal taxes, or has borrowed from a federal agency or from a bank on a federally guaranteed loan, or has purchased the property from the Government on mortgage.³⁷⁷ The property, therefore, remains subject to property taxation to its full extent.³⁷⁸ However, the tax must be satisfied from the owner's equity, if any, or at the expense of the non-federal interests, unless Congress consents to subject the federal interest to the burden.³⁷⁹ Even if the non-federal interest has, in all other respects, priority over the federal mortgage or lien, it is the former that will be diminished by the property tax, at least if the courts apply the circular priority principle discussed and illustrated in Part I³⁸⁰ which was applied in federal tax lien cases before the recent legislation.

Congress in 1966 eliminated that problem with respect to federal tax liens by consenting to the superpriority not only of real property taxes, but also of special assessments for public improvements and certain charges for public services, whenever state law provides therefor.³⁸¹ The problem has also been narrowly confined where Small Business Administration loans are involved, because Congress has expressly consented to the subordination of the Government's security interests to subsequent liens for taxes on the property³⁸²—a consent which is

377. See *United States v. Ringwood Iron Mines, Inc.*, 151 F. Supp. 421, 426 (D.N.J. 1957), *aff'd*, 251 F.2d 145 (3d Cir. 1958), *cert denied*, 356 U.S. 974 (1958) (dictum of district court, critical of the result it felt compelled to reach, in preferring the federal mortgage).

378. *New Brunswick v. United States*, 276 U.S. 547 (1928); *S.R.A., Inc. v. Minnesota*, 327 U.S. 558 (1946).

379. *United States v. City of New Britain*, 347 U.S. 81 (1954) (federal tax lien); *New Brunswick v. United States*, 276 U.S. 547 (1928); *United States v. County of Iowa*, 295 F.2d 257 (7th Cir. 1961); *United States v. Roessling*, 280 F.2d 933 (5th Cir. 1960); *United States v. Ringwood Iron Mines*, 251 F.2d 145 (3d Cir. 1958); *Jamaica Sav. Bank v. Morgan*, 226 F. Supp. 668 (E.D.N.Y. 1962) (judgment lien for unsecured federal loan).

380. P. 232 and cases cited note 31 *supra*.

381. INT. REV. CODE of 1954, § 6323(b)(6). As pointed out at note 39 *supra*, circular priority can still arise when a federal tax lien is superior to an attachment, a landlord's lien, a state or local tax (other than a real property tax), or a mechanic's lien (enjoying a higher priority under state law than Congress was willing to grant it), if such other lien is superior to a private mortgage under state law. Such other liens can also create circular priority problems where the federal interest is a mortgage or judgment, as in the *Agsten* case, note 372 *supra*, where the mechanic's lien, held not to be "choate" as against the federal second mortgage, was satisfied at the expense of the private first mortgage.

382. 15 U.S.C. § 646 (1964). Like the Federal Tax Lien Act, it does not refer to liens for interest and penalties on property taxes, *United States v. Christensen*, 218 F. Supp. 722, 729 (D. Mont. 1963), and does not embrace corporate income and capital taxes for which state law attempts to impress prior liens on the property, *In re Lehigh Valley Mills, Inc.*, 341 F.2d 398 (3d Cir. 1965). It also does not extend to loans made by the S.B.A.

broader than that of the Federal Tax Lien Act in that it extends to personal property taxes,³⁸³ but narrower in that it omits reference to special assessments³⁸⁴ and to charges for public services.³⁸⁵ Many other statutes governing federal loan and guarantee programs consent to the taxation of real property *taken over by foreclosure*, but are silent concerning the priority of property taxes accruing while the property was still in private ownership.³⁸⁶ The Government maintains in such cases that pre-foreclosure property taxes are inferior to its mortgages or judgments, and must be satisfied at the expense of the prior private mortgagee, if any, under the circular priority principle. But the courts have uniformly held that those statutes evidence a Congressional purpose to permit subordination of the federal mortgage or judgment lien to any tax to which a fee title in the Government would be subject.³⁸⁷

The laws governing federal loan programs are not entirely uniform, however, in waiving property tax immunity. Occasionally they provide for specified or negotiated payments *in lieu of* property taxes on foreclosed properties, and such provisions are not susceptible to the construction that they imply consent to the *priority* of property taxes over federal liens.³⁸⁸ Sometimes there is no provision on the subject, as in the statutes governing the Economic Development program, under

merely as agent for another federal program (e.g., Economic Development, 42 U.S.C. § 3142(b)(9)(c) (Supp. I, 1965)).

383. *United States v. Clover Spinning Mills Co.*, 373 F.2d 274, 278 (4th Cir. 1966).

384. Other federal statutes consenting merely to the taxation of real property have been construed not to extend to special assessments for public improvements benefiting the property. *Board of Directors of Red River Levee Dist. No. 1 v. Reconstruction Fin. Corp.*, 170 F.2d 430 (8th Cir. 1948).

385. *United States v. Oswald & Hess Co.*, 345 F.2d 886 (3d Cir. 1965).

386. "The congressional policy appears to have been to waive tax exemption on real property owned by government corporations whose functions were primarily financial in nature." *Rohr Aircraft Corp. v. San Diego County*, 362 U.S. 628, 630-31 (1960). E.g., various agricultural credit programs (7 U.S.C. § 1984 (1964); 12 U.S.C. §§ 931, 933, 1020f(a) [*repealed*, Act of Oct. 4, 1961, Pub. L. No. 87-353, § 3(a), 75 Stat. 773] 1111, 1138c (1964); 15 U.S.C. § 713a-5 (1964)); National Housing Act (12 U.S.C. §§ 1706(b), 1714, 1723a(c), 1741, 1747j, 1750e (1964)); Federal Deposit Ins. Corp. (12 U.S.C. § 264(p) (1964)); Reconstruction Finance Corp. (15 U.S.C. § 607 (1964)). Only the last, which is no longer operative, mentions special assessments, which Congress added in 1947, apparently as a reaction to the litigation referred to in note 384 *supra*.

387. *United States v. Mays*, 264 F.2d 317 (10th Cir. 1959); *United States v. City of Springfield*, 190 F. Supp. 817 (D. Mass. 1961), *aff'd per curiam*, 294 F.2d 958 (1st Cir. 1961); *Jamaica Sav. Bank v. Zeus Capital, Ltd.*, 67-1 U.S. Tax Cas. ¶ 9120 (E.D.N.Y. 1966); *Dime Sav. Bank v. Beecher*, 23 App. Div. 2d 297, 260 N.Y.S.2d 500 (1965), *appeal dismissed*, 17 N.Y.2d 725, 216 N.E.2d 838 (1966). The two latter cases involved judgments for federally insured loans, junior to private mortgages, in which the Government unsuccessfully invoked the circular priority principle to shift the burden of the property tax to the prior mortgagee.

388. *United States v. Roessling*, 280 F.2d 933 (5th Cir. 1960), involving Act of June 30, 1936, ch. 881, 49 Stat. 2036 (Resettlement Administration). A similar provision now in effect is 12 U.S.C. § 1749a(c)(5) (1964) (Housing for Educational Institutions).

which private lenders are encouraged to participate in business loans by putting up first mortgage money and the Government agrees to take a subordinate lien for the additional funds needed.³⁸⁹ In pending litigation thereunder, the Government is contending that its second mortgage is superior to the property tax liens, and hence that the property taxes must come out of the share of the first mortgagee under the circular priority principle.³⁹⁰ Such treatment can hardly contribute to the confidence of prospective private participants in Government development programs.

In addition, circular priority problems, or loss of revenue to local governments if there is no private mortgagee to bear the brunt, can also arise in connection with federal mortgages and judgments not arising out of loans and guarantees.³⁹¹ In such cases, if there is any applicable statutory waiver of immunity, it is more likely to be of the "in lieu" type, which is no help on priorities.

Congress recognized a number of other superpriorities in the Federal Tax Lien Act, some of which may be pertinent to the present discussion. One relates to possessory liens for the repair or improvement of personal property, which now have been granted priority even over pre-existing federal tax liens, in recognition of the facts that such services ordinarily enhance or preserve the value of the lien property and that searching for federal tax liens is rarely practicable in such cases.³⁹² The Act thus follows the lead of the Uniform Commercial Code, which similarly favors such possessory liens over security interests in the nature of chattel mortgages.³⁹³ Yet a federally held chattel mortgage has been held superior, under the "first in time" rule, to an artisan's or repairman's lien for work performed at the request of the owner in possession.³⁹⁴

389. 42 U.S.C. § 3142(b)(9)(C) (Supp. I, 1965).

390. *Mellon Nat. Bank & Trust Co. v. Automated Storage, Inc.*, decided adversely to the Government on August 16, 1967, by the Court of Common Pleas of Allegheny County, Pa. (No. Ex. 376, Oct. Term 1966) involving the predecessor Area Redevelopment Act, 42 U.S.C. § 2505(b)(9)(D) (1964).

391. Cases cited note 364 *supra*. The Government argued the circular priority principle in *Empire State Collateral Co. v. Bay Realty Corp.*, 232 F. Supp. 330 (E.D.N.Y. 1964), where it had been given a second mortgage to secure delinquent federal taxes, but it was unsuccessful for reasons peculiar to the case.

392. INT. REV. CODE of 1954, § 6323(b)(5). See H.R. REP. No. 1884, 89th Cong., 2d Sess. 5 (1966). It is argued, in Part IV.B.10 in the second installment of this article, that such superpriority ought, in equity, to be extended to liens for carriage or storage of property.

393. UNIFORM COMMERCIAL CODE § 9-310. See Comment, *Nonconsensual Liens Under Article 9*, 76 YALE L.J. 1649 (1967).

394. *Southwest Engine Co. v. United States*, 275 F.2d 106 (10th Cir. 1960). Although the court fortified its position by finding that state law, if applicable, would in any event have denied the repairman's priority, the decision rests primarily on the "federal common law" concept of "first in time." Cf. cases cited note 397 *infra*.

The Federal Tax Lien Act also recognizes superpriorities for retail purchasers of goods in the ordinary course of business, and certain casual purchasers who could not be expected to search the records for existing federal tax liens.³⁹⁵ Those provisions resemble the protection which the Uniform Commercial Code grants to purchasers of goods which are subject to a security interest.³⁹⁶ Yet the Government, applying the "federal common law" which may still prevail outside the tax lien field, may well contend that a federally held security interest cannot be displaced by a later purchase by an innocent party. At least, it has contended, albeit with only mixed success, that a dealer or auctioneer who sold a farmer's cattle on the livestock market, in ignorance of a federal security interest, was liable to the Government for conversion regardless of state law.³⁹⁷ It is but a short step to arguing that, notwithstanding the Commercial Code, an innocent purchaser is also subject to the Government's interest.

I urge the appropriate units of the Bar to draft and present to Congress legislation to roll back the insidious spread of "federal common law" concerning the priorities of federal mortgages, judgments and other non-tax liens. The fact that a unanimous Congress went as far as it did in rolling back the priorities of federal tax liens affords a precedent. For if the "imperious need" for raising tax revenue³⁹⁸ is no longer thought to demand maintenance of unconscionable rules of priority, *a fortiori* should not those rules be abandoned when the Government "step[s] down from that place of sovereignty to enter the domain of business and commerce,"³⁹⁹ as a lender or guarantor of loans, or as a seller of property?

We have observed that Congress stopped short of unqualified adop-

395. INT. REV. CODE of 1954, § 6323(b)(3), (4). See Part IV.B.4 in the second installment of this article.

396. UNIFORM COMMERCIAL CODE § 9-307.

397. "Federal common law" was held controlling in *United States v. Carson*, 372 F.2d 429 (6th Cir. 1967); *United States v. Somerville*, 324 F.2d 712 (3d Cir. 1963); *United States v. Matthews*, 244 F.2d 626 (9th Cir. 1957). But state law was given effect in *United States v. Union Livestock Sales Co.*, 298 F.2d 755 (4th Cir. 1962); *United States v. Kramel*, 234 F.2d 577 (8th Cir. 1956); cf. *Bumb v. United States*, 276 F.2d 729 (9th Cir. 1960), holding federal mortgage loans to be subject to the notice requirements of state bulk sales laws and (by dictum) to state recording requirements. This is in significant contrast to the rules on federal tax liens, which can be subjected to state recording laws only as Congress expressly consents thereto. *United States v. Union Central Life Ins. Co.*, 368 U.S. 291 (1961); *United States v. Snyder*, 149 U.S. 210 (1893).

398. See *Bull v. United States*, 295 U.S. 247, 259 (1935); *Tyler v. United States*, 281 U.S. 497, 503 (1930); cf. *United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 51 (1950); *Price v. United States*, 269 U.S. 492, 499-500 (1926).

399. *United States v. Ringwood Iron Mines, Inc.*, 151 F. Supp. 421, 426 (D.N.J. 1957) (dictum). See also *Rohr Aircraft Corp. v. San Diego County*, 362 U.S. 628 (1960).

tion of state law where federal tax liens are concerned.⁴⁰⁰ Federal taxes must be collected nationally with an even hand, and a degree of uniformity is desirable.⁴⁰¹ But "it is not asking too much from a federal agency, which has embarked upon the business of lending money in competition with private firms and individuals, simply to be governed by the same local law which controls the rights of private citizens in a similar endeavor."⁴⁰² The interests of the Government and of third parties "will be properly protected if the local rules governing dealings in the transfer of property, which have been built up by experience in like transactions and are familiar alike to the courts and the citizens of the several localities, are given application."⁴⁰³ Accordingly, the fact that Congress declined to accept some state rule of priority or superpriority, as applicable against a federal tax lien, does not necessarily mean that it should not now accept such rule in situations where the Government acts, not as a tax collector, but as a voluntary creditor able to contract with reference to such rules.⁴⁰⁴

The desirability of adopting state rules in this respect is particularly evident with respect to commercial credit transactions where the Uniform Commercial Code, now adopted by 49 states and by Congress itself for the District of Columbia,

is thus on its way to becoming a truly national law of commerce, which . . . is "more complete and more certain, than any other which can conceivably be drawn from those sources of 'general law' to which [the courts] were accustomed to resort in the days of *Swift v. Tyson*" When the states have gone so far in achieving the desirable goal of a uniform law governing commercial transactions, *it would be a distinct disservice to insist on a different one for the segment of commerce, important but still small in relation to the total, consisting of transactions with the United States.*⁴⁰⁵

In areas outside the scope of the Commercial Code, such as liens on real property, the case for Congressional adoption of widely varying state rules of lien priority, superpriority, and relation back may be less

400. Pp. 232-33 *supra*.

401. 84 A.B.A. REP. 647-48 (1959); Compare *United States v. Gilbert Associates*, 345 U.S. 361, 364 (1953), with *United States v. Brosnan*, 363 U.S. 237, 240-242 (1960).

402. *United States v. Cless*, 254 F.2d 590, 594 (3d Cir. 1958); cf. pp. 245-46 *supra*.

403. See *United States v. Union Livestock Sales Co.*, 298 F.2d 755, 759 (4th Cir. 1962).

404. See *United States v. Yazell*, 382 U.S. 341 (1966), holding a federal lending agency bound by state rules concerning the mortgagor's capacity to contract.

405. *United States v. Wegematic Corp.*, 360 F.2d 674, 676 (2d Cir. 1966) (emphasis added). See also *In re Portland Newspaper Pub. Co.*, 271 F. Supp. 395, 400 (D. Ore. 1967).

clear. Yet arguments in favor of such adoption are not lacking. As a voluntary lender, guarantor, or seller, the Federal Government is as well able as any private party to take into consideration the potential effect of "inchoate" liens and to allow a margin of safety for future liens that may enjoy superpriority under state law. To reject the application of such rules is to shift to others the burden and risk of federal loan and guarantee programs, which are designed, at least in part, to make credit more freely available in marginal situations. That federal policy may be neutralized if the risks incurred by private, uninsured creditors are increased, thereby discouraging their extension of credit to the beneficiaries of such federal programs.⁴⁰⁶

Particularly in the case of guaranteed loans or those in which a federal agency has an undisclosed "participation," the potential federal interest will ordinarily not appear of record, and one who justifiably relies upon his priority under state law may be entrapped when the mortgage is elevated above him by a subsequent assignment to the United States.⁴⁰⁷ Moreover, even when the federal interest is disclosed, as in the case of a direct loan, it may not be readily discovered if discrepancies between the federal and state rules require a search for federal interests at times or under circumstances when no search would otherwise be made by one relying upon his protection under state law. Variances that may have to be tolerated when only federal tax liens are concerned could become excessively burdensome when the risks are extended to the broad range of the federal loan and guarantee program.

It should also be noted that each variance between federal and state rules of priority involves a potential circular priority situation, in which a private first mortgagee or other prior-in-time creditor will be the loser.⁴⁰⁸ Such situations ought to be minimized if possible.

If Congress is nevertheless unwilling to adopt state rules completely, even when the Government is a voluntary creditor, I suggest the following for consideration:

(1) The infamous "choateness" doctrine should be eliminated in this area, at the very least to the degree that relief therefrom has been granted in the Federal Tax Lien Act; *i.e.*, with respect to mechanics'

406. P. 246 *supra*.

407. Pp. 247-48 & note 134 *supra*.

408. Note 381 *supra*.

liens, security interests involving future advances and after-acquired property, and mortgagees' expenses.⁴⁰⁹

(2) The remnants of the "choateness" doctrine that survive in the tax lien area should be scrutinized for their appropriateness in this different area, in the light of the considerations discussed above. The practical reasons that made Congress unwilling to subordinate a federal tax lien to future advances under an open-end real estate mortgage (other than for a construction loan),⁴¹⁰ for example, may not apply when the Government is a voluntary second mortgage lender or, particularly, when the lender is a private party for whom the Government acts merely as an insurer. And the refusal of Congress to allow a mechanics' lien apriority date, as against a federal tax lien, earlier than the commencement of the lienor's own participation,⁴¹¹ although at least half the states date it from the commencement of the entire project,⁴¹² may well be inappropriate in these other contexts. Relief might also be granted here to certain specific liens which, as against federal tax liens, were left subject to the full rigor of the "choateness" doctrine, but which should perhaps be permitted to compete on state-prescribed terms with federal liens involving "voluntary" credit; *e.g.*, attachments,⁴¹³ landlords' liens,⁴¹⁴ and state and local tax liens (other than those for property taxes).⁴¹⁵

(3) Congress should also consider extending and making uniform the consent to the superpriority of liens for real property taxes, special assessments, and charges for public services adopted in the Federal Tax Lien Act,⁴¹⁶ and possibly also the consent to such priority for personal property taxes on the mortgaged property provided in the Small Business Act.⁴¹⁷ This would be consistent with the policy already adopted with respect to many federal loan programs, as construed by the courts, but it would end the litigation that has resulted from the failure of most such laws to refer expressly to priorities and would eliminate discrepancies among them.⁴¹⁸

409. P. 232 & notes 32-37 *supra*.

410. INT. REV. CODE of 1954, § 6323(c)(3), (h)(1)(B).

411. Note 34 *supra*.

412. See Part IV.B.6, in the second installment of this article.

413. See Part IV.B.9, in the second installment of this article.

414. See Part IV.B.7, in the second installment of this article.

415. See Part IV.C.1, in the second installment of this article.

416. INT. REV. CODE of 1954, § 6323(b)(6).

417. Pp. 289-90 & notes 382-83 *supra*.

418. P. 290 & notes 386-87 *supra*.

(4) Other superpriorities recognized in the Federal Tax Lien Act, where they are relevant for present purposes, should be considered for adoption. In particular, the superpriority of possessory liens for services to personal property should be recognized, so far as it exists under applicable state laws.⁴¹⁹ Any doubt that the Commercial Code's protection of purchasers of goods applies with respect to federally-held security interests should be removed.⁴²⁰

(5) In the interest of equity, as well as of minimizing circular priorities, Congress should consider recognizing in the non-tax area the superpriority to the extent of the value added to the property which some state laws give to mechanics' liens as against pre-existing mortgages.⁴²¹

B. Procedure

1. Enforcement of Federal Mortgages

Even if state rules governing priorities and the protection of third parties were adopted in blanket fashion, it would not necessarily follow that state rules should govern the Government's *remedies on default*. The courts have held federal law (as embodied in regulations and forms of contract) controlling as against state laws restricting the right to a deficiency judgment⁴²² or to the appointment of a receiver.⁴²³ Since such matters affect not third parties but the consenting borrower, it may fairly be concluded that the protection of the borrower against the terms to which he agreed should be left to federal rather than state policy. Nevertheless, while I recommend no change, this question should be considered in any general review of the problems in this area.

2. Enforcement of Private Mortgages and Liens

In many states, the foreclosure of a mortgage must be effected by a court proceeding, with junior lienors named as parties and enabled to protect their interests at the sale. The Federal Government long ago consented to be named a defendant in such proceedings, in order that a junior mortgage, tax lien, or other lien held by the Government

419. P. 291 & notes 392-94 *supra*.

420. P. 292 & notes 396-97 *supra*.

421. Notes 372 and 381 *supra*.

422. *United States v. Shimer*, 367 U.S. 374 (1961); *McKnight v. United States*, 259 F.2d 540 (9th Cir. 1958). *But cf.* *Reconstruction Finance Corp. v. Breeding*, 211 F.2d 385 (10th Cir. 1954).

423. *United States v. View Crest Garden Apartments, Inc.*, 268 F.2d 380 (9th Cir. 1959), *cert. denied*, 361 U.S. 884 (1959); *United States v. Chester Park Apartments, Inc.*, 332 F.2d 1 (8th Cir. 1964).

might be discharged by the sale.⁴²⁴ However, the consent was conditioned upon a one-year right for the Government to redeem real estate from the sale, even when state law granted no such redemption right.⁴²⁵

On the other hand, some states permit the foreclosure of a mortgage or deed of trust by a judicial proceeding to which junior lienors need not be made parties, or by a nonjudicial sale without notice to junior lienors. Pledges and other security interests in personal property are also commonly enforced nonjudicially, as are many state and local tax liens. The Supreme Court, in a narrowly divided decision in 1960, determined that such state procedures were sufficient to divest a junior federal lien without notice to the Government, if that was the effect on junior lienors generally.⁴²⁶ The lower courts, however, declined to extend that principle to permit divestment of a *senior* federal lien, even when state law provided for divestment of senior liens.⁴²⁷

The Supreme Court was conscious that the protections which Congress had carefully provided for the Government in judicial foreclosures in which it was a party were swept away when alternative procedures were availed of by the senior mortgagee or lienor. But the majority of the court was unwilling to disturb the established pattern of procedures in the several states in the absence of specific guidance from Congress, which was in the best position to weigh the "competing considerations" and reach "a wise solution of such a far-reaching problem."⁴²⁸

Congress responded in the Federal Tax Lien Act of 1966⁴²⁹ by providing that:

(a) A federal tax lien may if state law so provides be discharged or divested by either a judicial or nonjudicial sale, without joinder of or notice to the Government, if notice of the tax lien is not filed by the time the judicial action is commenced or more than

424. 28 U.S.C. § 2410 (1964) (based on the Act of March 4, 1931, ch. 515, 46 Stat. 1528-29). The legislative history, including the 15-year effort of the American Bar Association to achieve this reform, is reviewed in Mitchell, *The Choateness Doctrine—Both Unconscionable and Unconstitutional*, 38 CONN. B.J. 252, 273-276 (1964).

425. 28 U.S.C. § 2410(c) (1964), before the 1966 amendment. *United States v. John Hancock Mut. Life Ins. Co.*, 364 U.S. 301 (1960).

426. *United States v. Brosnan*, 363 U.S. 237 (1960), involving federal tax liens. The same principle had been applied to discharge a junior federal mortgage in *United States v. Cless*, 254 F.2d 590 (3d Cir. 1958).

427. *United States v. Roessling*, 280 F.2d 933 (5th Cir. 1960); *United States v. Peterson*, 204 F. Supp. 683 (E.D. Pa. 1962); *United States v. Mojac Constr. Corp.*, 190 F. Supp. 622 (E.D.N.Y. 1960).

428. *United States v. Brosnan*, 363 U.S. 237, 251-52 (1960).

429. INT. REV. CODE of 1954, § 7425; 28 U.S.C. § 2410, as amended, Pub. L. No. 89-719 (1966), 80 Stat. 1125 (1966).

30 days before a nonjudicial sale,⁴³⁰ whether the federal tax lien is senior or junior in priority to the lien being foreclosed;⁴³¹

(b) A federal tax lien which is duly filed before the commencement of a plenary judicial foreclosure cannot be discharged without joinder of the United States;

(c) A federal tax lien which is duly filed more than 30 days before a nonjudicial sale may be discharged or divested pursuant to state law, but only if 25 days' notice of the sale (or shorter notice in exceptional situations)⁴³² is given to the Government in order that it may protect its interests; and

(d) The period for redemption of real property from a sale, where the Government's interest is a tax lien, was reduced from one year to 120 days, but the right was made applicable in the case of nonjudicial as well as judicial sales.⁴³³

The provision has flaws which should be corrected,⁴³⁴ but on the whole it protects the Government's legitimate interests without unduly interfering with local procedures. It substantially conforms to the purposes, although not the details, of recommendations which the American Bar Association made as long ago as 1956 and reaffirmed in 1959 on the basis of the Special Committee's study.⁴³⁵ The Bar proposals, however, were not limited to cases where the federal interest is a *tax lien*. The legislation enacted was so confined because of the limitations upon the jurisdiction of the congressional committees that handled it.⁴³⁶

430. A sale under confession of judgment is here, for convenience, included in the term "nonjudicial sale," and is distinguished from a "plenary judicial foreclosure."

431. A landlord's lien, for example, might be junior to an unfiled or after-arising tax lien, *United States v. Scovil*, 348 U.S. 218 (1955), but the foreclosure of the landlord's lien would divest the tax lien in the circumstances stated, at least if there is no foreclosure suit in which the United States is joined. *See* W. PLUMB & L. WRIGHT, *supra* note 3, at 236.

432. INT. REV. CODE of 1954, § 7425(c)(2), (3). Notice at any time before the sale will suffice if the property is perishable or if keeping it would cause great expense or loss of value. The notice period may also be shortened by consent.

433. Under prior law, it is probable that the Government had no right of redemption if it was not made a party to a suit under 28 U.S.C. § 2410. *See* *United States v. Bank of America*, 265 F.2d 862, 867 (9th Cir. 1959), *rev'd on other grounds sub nom. United States v. Brosnan*, 363 U.S. 237 (1960). *But see* *United States v. Boyd*, 246 F.2d 477, 485 (5th Cir. 1957), *cert. denied*, 355 U.S. 889 (1957).

434. Part V.E.2, in the third installment of this article.

435. 81 A.B.A. REP. 189 (1956); 84 A.B.A. REP. 737-38, 740-42 (1959). The Bar proposal would have provided 60 days' notice (which Congress shortened in order to accommodate sales of personal property) and would have abolished the right of redemption entirely (which Congress was unwilling to do, because the alternative of authorizing collection officers to protect the Government's interest by bidding at the sale, when there was a lien prior to the federal lien, necessitating an outlay of cash, was not thought feasible).

436. Other provisions on the same subject matter, however (extending the Government's consent to be sued to embrace condemnation, partition and interpleader suits [28 U.S.C. § 2410(a) (Supp. II, 1965-66)] and prescribing the redemption price [*id.* § 2410(d)]), were made generally applicable and were not confined to cases of tax liens.

As a result, two entirely different sets of rules may apply, depending upon what interest the Government claims in the property being foreclosed. Thus, a nonjudicial foreclosure can cut off a junior (and possibly even a senior) federal tax lien in accordance with state law if and only if the Government is given the prescribed notice, and then only subject to a 120-day right of redemption if real property is involved; but a nonjudicial foreclosure can still cut off a junior (but not a senior) federal mortgage or non-tax lien without notice, and probably with no right of redemption. A judicial foreclosure to which the Government is not a party cannot affect a federal tax lien which was on file when the action was commenced; but it can discharge a junior federal mortgage or non-tax lien if local law makes joinder of junior lienors unnecessary. A judicial foreclosure of real property, to which the United States is a party, can cut off a junior federal tax lien subject to a 120-day right of redemption; but if the Government holds a mortgage or non-tax lien, the redemption period is one year.

If the new rules are good, they are as good for federal mortgages as for tax liens. The appropriate committees of Congress should now consider making uniformly applicable the rules, largely for the Government's protection, which Congress unanimously approved with respect to tax liens.